Mr. David Bradbury
Head, Tax Policy and Statistics Division
Centre for Tax Policy and Administration
OECD
2, rue Andre Pascal
75775 Paris Cedex 16
France

By email to: TFDE@oecd.org

6 March 2019

Dear Mr. Bradbury

PricewaterhouseCoopers International Limited on behalf of its network of member firms (PwC) welcomes the opportunity to comment on the Public Consultation Document on Addressing the Tax Challenges of the Digitalisation of the Economy (PCD) as per the invitation for public input dated 13 February 2019.

PwC is particularly appreciative of the dedication of the members of the TFDE to reach global consensus. We believe a global solution can only be reached if all stakeholders (governments, businesses, advisers, academics, NGOs, and others) are prepared to be flexible in seeking approaches that address the unravelling of the global consensus, which led the G20 to commission the project. We note the proposals outlined in chapter 2 of the PCD stretch, and in some respects exceed, the boundaries of current principles of international tax law, which we view as reason for caution. That said, we recommend the search for consensus begin within the current principles which are acknowledged to work well for the vast majority of transactions and have been flexible enough to withstand many changes through their nearly 100 year history. Careful consideration should be given to major departures from existing principles, and to their legal compatibility (e.g. with EU-law) and consistency with the economic rationale (value creation) that forms the foundation of the current international tax regime.

If there is a move away from the arm's length principle (ALP), it must be based on a principled alternative approach. In most interactions, the ALP produces outcomes that are acceptable to businesses and governments, but there does need to be change if countries agree that they want to recalibrate or fine tune where profit should be considered to arise for corporate tax purposes.

The increased delivery of goods and services by electronic means, as well as new methods of, and tools for communication and interaction, has caused some to assert that income of a foreign company should be subject to tax in the market country as a result of accessing that country's

customer base, its infrastructure or other facilities. Various rationales are offered for principles to recognise the extent of involvement but they need to be critically assessed and consensus must be reached on well-defined and economically sound adjustments to the ALP. For example, why should only some types of "user participation" change the allocation of taxing rights and not other types of customer data routinely collected by business, and why should the tax system not be neutral regarding different technologies for collecting consumer data? As another example, why should the income attributable to some types of intangible assets developed through activities conducted abroad by foreign companies be taxed in the market country and not other intangible assets, and is it possible, in theory or practice, clearly to separate income from market and technological intangible assets? To what extent should thresholds and other carve-outs address global policy objectives, whether relating to maturity of business, certain business models or characteristics within an industry sector, etc?

Based on these observations, the TFDE might confirm that countries do not wish to consider reforms of the international tax system that are fully, rather than piecemeal, consistent with the principle of attributing more income tax rights to market jurisdictions. Such possible reforms include a global version of the Common Consolidated Corporate Tax Base (CCCTB) proposal developed by the European Commission, and the Destination-Based Cash Flow Tax (DBCFT) developed by Alan Auerbach and Michael Devereux.

The new and comprehensive global anti-base erosion proposals in chapter 3 of the PCD seem premature. The impact has yet to be assessed of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project final reports published in 2015, some of which are still to be fully implemented. Nevertheless, we appreciate that many countries believe there are lingering issues from the original BEPS Project and that additional measures are necessary to combat arrangements that result in minimal to zero taxation. If countries agree to take action which may result in double taxation (particularly if withholding tax were included as a collection mechanism) and increased tax compliance burdens on taxpayers and tax authorities, care might be taken specifically to target aggressive and artificial arrangements only.

Given the fundamental changes to the long-standing international tax architecture that are included in the proposals in the public consultation document, a full analysis of the administrative burdens and economic consequences would seem essential before any final decisions are made. We recognise that such an analysis may not be completed by 2020, but believe there is more risk to the global economy of hasty action without such analysis, than delayed decision-making based on more complete information. Any action should also be accompanied by measures to deal with the increased number of disputes which may arise, some of which are likely to be multilateral in scope, and mandatory binding arbitration should again be considered as a minimum standard.

The architect Louis Sullivan said, "It is the pervading law of all things … that form ever follows function." This is no less true in the design of tax law than buildings. We must start from a clear understanding of the function of the law before its form can be delineated. It is not possible for international tax rules simultaneously to follow the ALP and to allocate income to market countries beyond what can be justified by this principle. The risk of building a new international tax architecture on a set of inconsistent foundational principles is that it will not prove stable nor assure that all income is subject to tax once and only once.

Appendix 1 to this response outlines our responses to the different questions and views on the various sections of the public consultation document and follow the same order. Appendix 2 provides the results of a PwC survey on familiarity with, and use of, profit split methods in 22 countries.

For any clarification of this response, please contact the undersigned or any of the individuals below. We look forward to discussing any questions you might have on the points we raise above or on other specific matters raised by respondents to the invitation for public input, and we welcome the opportunity to contribute to the discussion as part of a public consultation meeting to be held on 13 and 14 March 2019.

Yours sincerely,

Stef van Weeghel, Global Tax Policy Leader
stef.van.weeghel@pwc.com
T: +31 (0) 887 926 763

PwC Contacts	**Email**
Will Morris	william.h.morris@pwc.com
Edwin Visser	edwin.visser@pwc.com
Pam Olson	pam.olson@pwc.com
Giorgia Maffini	giorgia.maffini@pwc.com
Dave Murray	david.x.murray@pwc.com
Stefaan de Baets	stefaan.de.baets@pwc.com
Aamer Rafiq	aamer.rafiq@pwc.com
Isabel Verlinden	isabel.verlinden@pwc.com
Romero Tavares	romero.tavares@pwc.com

Phil Ramstetter	philip.s.ramstetter@pwc.com
Steve Nauheim	stephen.a.nauheim@pwc.com
David Ernick	david.ernick@pwc.com
Richard Jerabek	richard.jerabek@pwc.com
Phil Greenfield	philip.greenfield@pwc.com

Appendix 1

Detailed consideration of challenges and proposals

Executive summary

A. Introduction

The PCD reiterates the objectives of a project that is highly ambitious in many ways. However, it is an essential project given the clear concerns of participating countries, and the willingness of many to enact harmful unilateral measures in the absence of broader international reform, which must be multilateral in order to be effective.

The number of countries in the Inclusive Framework increases (129 at the time of writing), and now far exceeds the number of countries involved in agreeing the two most inclusive global tax reform initiatives to date: the final 2015 BEPS Project recommendations, and the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the Multilateral Instrument).

While the countries have agreed to look at all four proposals on a "without prejudice" basis, it is clear that the two "pillars" (and even the proposals within these pillars) are seeking to address very different concerns. Concerns with the existing allocation of taxing rights - in response either to online platforms, Limited Risk Distributors (LRDs), or broader historic concerns - are fundamentally different to each other and to those around the ability of countries and companies to benefit from low tax rates.

Something the four proposals do share is their ambition. Each would be a fundamental departure from the existing international tax framework. Each face significant technical and practical challenges, and could bring much disruption and uncertainty in their wake.

It is implied (although not certain) that elements from each "pillar" will be taken forward simultaneously. Reaching agreement that takes forward sufficient elements of each proposal to address proponents' concerns while also ensuring the international tax framework remains tethered to overarching coherent principles will require much work and compromise.

The time frame is very short. The BEPS Project sought to address predominantly anti-avoidance measures among a smaller group of countries. Only a few of these measures required treaty changes rather than aligned domestic rule changes, and many such treaty changes were not minimum standards. However, it seems unlikely that any of the proposals (and especially those seeking to address profit allocation and nexus) could be effective without treaty changes.

We continue to support the OECD as the organisation best suited to take on these challenges and build a truly global and principled consensus to encourage cross border trade and growth. In addressing the objectives and challenges above, there are several more practical issues and challenges that will need to be taken into account. Our response seeks to highlight and address these challenges in a constructive way.

B. Overarching challenges

A key challenge for the success of the entire project is the cohesiveness of the proposals, and whether they can be united in a coherent manner. The three profit allocation and nexus proposals have differing objectives because they seek to address different perceived problems. The challenges in uniting these proposals may be more political than technical, but in any case they will be best achieved through a deep political agreement on the challenges faced and principles on which the international tax system should be built. The global anti-base erosion proposal has more of an anti-avoidance focus, and does not face the same internal challenges regarding objectives. However, it has multiple elements, and as the PCD recognises, coordination rules will be essential if it is to proceed. The biggest coordination challenge will be faced if it is decided that profit allocation, nexus, and anti-base erosion proposals are required to be introduced simultaneously, as each could impact each others operation. If such an approach is taken, there may be merit in seeking to identify whether elements of each proposal are already resolved to some extent in the outcomes of the other.

Significant changes bring about significant uncertainty and the increased risk of double or multiple taxation. While the anti-base erosion proposal seems more likely to result in double taxation due to its mechanical operation (combined with differences in domestic law on vital areas such as tax bases, tax rates, and timing), the profit allocation proposals all imply a drive towards (multilateral or bilateral) profit sharing mechanisms, which increases the risk of differing tax administration interpretation. It is clear that existing dispute prevention and dispute resolution mechanisms will need to be improved (and potentially broadened to work multilaterally) if these challenges are to be addressed.

A key concept not given the attention it deserves in the PCD is the allocation of losses as well as profits. Relevant activities can generate losses as well as profits, and accordingly they too should be allocated in line with the same principles (on a formulaic or other basis if that is the agreed consensus approach). A lack of focus here would give rise to significant challenges both on transition to new rules and in the future.

More details are provided on these and other broader challenges in Section 1 below.

C. Profit allocation and nexus proposals

While we believe it is essential that nexus thresholds and profit allocation mechanics are agreed together as part of a comprehensive package, we believe that profit allocation must be addressed first, and used to influence the design and level of an appropriate nexus threshold that excludes incidental activities and those which would not attract significant profit allocation in any event. The existence of a taxable presence can result in significant cost, and it is important (to businesses, to tax authorities, and for cross border trade, investment and growth) that this obligation is not triggered when the income to be allocated is not commensurate with these costs.

For profit allocation, three proposals seek to shift taxable income to “market” jurisdictions: the marketing intangibles proposal, the user contribution proposal, and the significant economic presence proposal. The PCD is open about the fact that new ways of allocating income under

each could go beyond the ALP. In our response to the PCD, we first ask the Inclusive Framework to provide a comprehensive explanation of why the system needs to be moved away from the ALP and into a new, untested system. PwC strongly believes that the solution should first be sought in the correct application of the internationally agreed ALP, with consideration of adjustments for the objectives of the Inclusive Framework. If a departure is required, this must be rooted in a detailed evaluation of the reasoning for doing so, and what principles will guide the new allocation, if it is to be sustainable.

The PCD suggests two broad mechanisms for allocating income to destination: residual profit splits and a formulaic approach. We describe the advantages and the challenges of the former method also on the basis of a survey of our network firms which finds that profit splits remain a peripheral method and are considered rather burdensome for the taxpayer. We then highlight how a formulaic, unprincipled way of attributing income to destination could reward very different market jurisdictions with the same income and importantly, incentivise increasing claims on the tax base, thus making the international tax system unstable.

It is reiterated in paragraph 1 of the PCD that the digital economy cannot be ring-fenced from the rest of the economy, yet across two of the three proposals, some businesses or business models would be treated differently or segregated from others.

More details are provided on these broader challenges in Section 2 below.

D. Global anti-base erosion proposal

The final proposals in the OECD/G20 BEPS Project reports have yet to be systematically implemented. Thus, while we are cognisant that many countries feel there are unresolved issues, we caution against moving forward with new rules seeking to address similar concerns before we are able to properly analyse the empirical results - as mandated in the final Action 11 Report. The PCD does not appear to contain novel or specific issues, and without clear policy objectives in mind, we find that our ability to provide constructive feedback is limited.

The PCD proposes two ambitious measures - a global minimum tax and two base eroding payment provisions. In our view, these measures raise significant business concerns with corresponding negative economic impacts. Any proposals should thoughtfully and explicitly address design and reporting issues and must seek to minimize administrative complexity, eliminate double taxation, provide effective dispute resolution mechanisms, and outline clear coordination rules (between all new proposals as well as existing regimes).

Lastly, we believe any proposals should remain tethered to longstanding and well-founded international tax principles, which link taxing rights to economic realities. International tax rules should also preserve countries' sovereign rights to determine fiscal policies (e.g., tax rate, tax base, incentives, etc.) to achieve their economic prerogatives. We therefore encourage the targeted drafting of rules to address specific harmful tax practices, as opposed to arbitrarily denying benefits or simply applying a higher rate of taxation on foreign earnings.

More details are provided on these broader challenges in Section 3 below.

Section 1: Tax Challenges of the Digitalisation of the Economy: Key Challenges

The proposals in Chapter 2 and Chapter 3 of the PCD are discussed respectively in sections of our own response below. However, in addition, several overarching challenges sit alongside these more specific challenges.

A. Coherency of global solution and interaction of proposals

The proposals in the PCD address two distinct tax policy issues, i.e., concerns with the existing allocation of taxing rights and curbing the ability of countries and companies to benefit from low tax rates (regardless of whether they are deemed to have been allocated in a way that was agreed to be harmful under BEPS Action 5). It is implied (although not certain) that elements from each "pillar" will be taken forward simultaneously. Many transactions would be affected by both, if elements of each are taken forward simultaneously.

A key feature of the global anti-base erosion proposal is that it seeks to identify the effective tax rate of entities or payments (either in aggregate or individually). A significant challenge to administering and complying with this proposal (and to a certain extent in commenting throughout this response on its potential impact) would be simultaneous changes to where the transactions (or entities' profits) in question are subject to tax, particularly where the payments display fungibility. For example, where a royalty payment is made to an IP owner, but then, after routine functions are rewarded, a residual (forming the residual of a collection of royalties) is reallocated in part to a number of "market" or "user" jurisdictions, it is challenging to determine the effective level of tax to which the royalty was subject. The example is further complicated where some or all of the royalty payments were subject to withholding tax.

Given the breadth of transactions that would need to be examined under the global anti-base erosion proposals, and the significant number of countries that could be allocated a share (even if a limited share) of residual profits (or all profits) under the profit allocation proposals, a key design consideration in such a proposal would be whether the taxpayer should seek to allocate (potentially fungible) income to specific countries (either in an arbitrary or principles based fashion). Either has clear challenges in administrability both by taxpayers and tax authorities, and could result in double taxation. In addition, this highlights the challenges that would apply in seeking redress from double taxation under bilateral treaties, which is discussed further below.

In addition to the clear challenges, there may be an opportunity in this observation. If there are scenarios where the objectives of one of the proposals are met by another concurrently applied proposal, then there would be clear benefits in reducing the application/ scoping of one of the proposals.

B. Double taxation and dispute resolution

A higher degree of complexity seems unavoidable in order to achieve the policy goals stated in the PCD. Seeking to tax business profits, particularly in the digitalising economy, is inherently complex and poses numerous administrative issues, leading to uncertainty and complexity. However, taxing trade and revenues instead (as some countries seek to do as so-called "interim"

measures) raise a range of efficiency, incidence and policy concerns[1], and we agree that a solution must be found that seeks to share taxing rights on net income (profits).

Such measures risk increased instances of harmful double taxation where effective dispute mechanisms are lacking and exacerbation of already worsening administrative burdens globally. We think any proposal that strays from or abandons long-standing international tax principles needs special attention. The concepts of value creation and the ALP have a foundation in supportable economic theory and have been observed and followed for years. To a large extent these foundational concepts govern the principles of international taxation in an applicable and proven manner.

Any consensus around the allocation of taxing rights should ensure income is allocated in a consistent, coherent, and agreed upon manner to avoid taxation of the same income across multiple jurisdictions. To prevent an adverse outcome resulting in double taxation, the recommendations must take into account the interaction of new rules with existing regimes (e.g. UK Diverted Profits Tax, existing CFC rules, anti-hybrid rules, withholding taxes, etc.) and in particular any additional reallocation of taxing rights under the other proposals, if they are taken forward concurrently (it will be difficult to determine a tax rate of the income received if that income is subsequently reallocated to multiple other territories - for example under the other three proposals).

We suggest any global-base erosion proposal and any proposal advocating a reallocation of taxing rights should therefore include a requirement for (mandatory) binding arbitration and other tax certainty measures to provide opportunity for remediation. This work should continue and build upon the efforts of the BEPS Project as outlined in the final Action 14 report (*Making Dispute Resolution Mechanisms More Effective*). Absent compulsory mechanisms for dispute resolution, double taxation and other taxpayer concerns may be left entirely unaddressed as each country pursues its own fiscal prerogatives.

Further, if there is a consensus report on this new global base erosion proposal, we would strongly recommend that (mandatory) binding arbitration and other dispute resolution mechanics be added to any new BEPS minimum standards of the Inclusive Framework.

Noting particularly the example above and the potential interaction with other proposals outlined in the consultation, it seems that in order to be effective, such a mechanism would need to be multilateral. This could be an opportunity to address the disparities that still exist regarding dispute resolution (e.g. differences in application of the Article 23 minimum standard and the time this will take to implement outside of the MLI), interaction with differing domestic measures, and the relatively small number of countries committed to binding arbitration). Such a mechanism would be challenging, with last best offer arbitration being challenging to implement in a multilateral context and independent opinion arbitration potentially setting precedents. A number of countries may be uncomfortable with one, the other, or both (in a bilateral or multilateral context). However, agreement on one is imperative to ensure the efficient functioning of any such move toward reallocation of the tax base away from transfer pricing principles.

[1] https://www.pwc.com/gx/en/tax/tax-policy-administration/assets/pwc-dtsg-literature-review-final.pdf

C. Losses and allocation of costs

A key concept not given the attention it deserves in the PCD is the allocation of losses as well as profits. The existing international consensus looks to specific functions, assets and risks in a jurisdiction to allocate either profits or losses to it. If proposals seek to allocate additionally a portion of other profits, there should be no tax if there are no respective global profits, and if there is a respective loss generated in relation to the concepts on which profit is allocated, then a share of the loss should be attributed. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TPG) consistently refer to the allocation of profits and losses and it is a fundamental feature of the underlying principles of taxation (and consistent with the concept of aligning taxing rights with value creation) that any solution agreed ensures that a share of losses is also attributable where an enterprise's relevant activities generate them (or on a formulaic or other basis if that is the agreed consensus approach).

In addition to considering losses and expenses on an annual basis, any change to the nexus and profit allocation rules may raise difficult technical questions around tax treatment of such a transition. Transition rules should ensure market and innovation jurisdictions are equitably treated. If innovation country entities face an exit charge related to the transition (either because it deems a disposal, or because the enterprise has to reallocate ownership of assets to align with the new regime), it will be critical that market jurisdiction entities obtain a fair market value basis in the marketing intangible allocated to their jurisdiction that could be amortised over time. The deduction in determining profits in the market jurisdiction should help ensure alignment with the economic outlays required to establish the business locally.

As well as during initial transition, this is also critical in the future where a new market is entered into by an enterprise after relevant intangibles have been developed. If, at that point, the market country becomes entitled to tax a portion of global residual profits that it would not have been entitled to before, a mechanism must be found that acknowledges the relevant historic costs/ losses that the enterprise has made that contribute to that residual and that market.

D. Treaty and domestic law changes

As noted above, treaties will need to be changed to introduce the allocation rights under any revised nexus approach; using the same or a similar mechanism to the Multilateral Instrument giving effect to BEPS treaty changes could ensure a consistent approach. However, given the potential departures from the single entity approach (both under the profit allocation and global base erosion proposals), amendments to bilateral treaties alone may not be sufficient or indeed the most coherent way of implementing such changes, and could result in significant numbers of bilateral treaties applying to the same underlying allocation of taxing rights between a number of countries; dispute resolution in particular would be challenging under such a network of treaties. It should be explored whether it would be possible to introduce a multilateral treaty with legal force of its own (rather than to amend existing bilateral treaties), that includes multilateral dispute resolution mechanisms (and preferably binding multilateral arbitration mechanisms).

Modifications to the domestic legislation of the countries will also be required as treaties do not generate new taxing rights and a peer review process similar to those introduced in relation to BEPS minimum standards would be useful to monitor appropriate implementation.

E. Accounting methods and legal obligations

To the extent that allocation keys would be used to divide profits, losses, and/or expenses across different jurisdictions, the agreed-upon framework should provide clear guidance regarding the method for determining profit, revenue or other allocation keys in order to ensure consistency. To the extent required, guidance should also be provided, either by the Inclusive Framework or individual members, relating to reconciliation of the agreed-upon accounting method under the framework and applicable accounting methods used for local tax purposes.

It is not clear whether taxpayers would be incentivised to make payments to entities where the income will be allocated for tax purposes. This may be necessary in order to avoid complex accounting challenges, but also to ensure the income is allocated appropriately in order to pay the taxes due. This may provide challenges in particular in relation to fiduciary duties and the interaction with minority interests.

F. Definitional clarity

There are a number of points made below in relation to the need for clear definitions, particularly in relation to the concept of the Residual Profit Split Method (RPSM). We further highlight below other terms that may be susceptible to differing interpretations that should be eliminated to the extent possible in order to promote a common understanding among taxpayers and tax authorities as to application of the framework. This is especially important with respect to qualitative factors that may be involved in determining application of the framework to taxpayers.

The recent experience of some countries in drafting legislation for Digital Services Taxes (DSTs) - which appear to be seeking to ring fence the same or similar populations of businesses as the user contribution proposal - has highlighted that one of the major challenges is to find a definition for in-scope revenues or activities that does not become too wide. This has been more challenging in relation to proposals that seek to identify in-scope activities rather than revenues. In consultations over such measures, it is clear that a lot of businesses are at the margin (or in so-called "grey areas") with some activities, and many companies have found it challenging to assure themselves that such ring-fenced measures as DSTs do not apply to them in any case. In its assessment of the user contribution proposal, we encourage the Inclusive Framework to examine the experience of the countries implementing DSTs and the challenges tax authorities and businesses have encountered with respect to the scope of such taxes.

In particular, the following areas have posed concern to businesses commenting on such measures:

- definition of "users"
- identification of users' locations and other issues regarding information available
- identification of revenues in scope (particularly in relation to "bundled" goods and services), and

- identification of activities that are linked to activities or revenues (a symptom of the challenge of defining those revenues or activities with specificity), and in particular the difference between distribution and marketplaces.

G. Broader economic implications

Without more details on the features of the proposal being studied by the Inclusive Framework, it is difficult to draw conclusions on the economic and behavioural implications of any new system. Here, we will sketch only broad possible trends and we suggest the Inclusive Framework consider again the economic and behavioural implications of the proposals once the design of the measure becomes clearer, possibly through another consultation with stakeholders and detailed economic analysis.

The minimal economic assessment of tax policy measures should consider at least three main issues:

1. *The effect of the proposals on the size and location of investment*. The tax system affects business investment decisions mainly through the cost of capital. Without more details on the design features of the proposal, including rate and features of the tax base, it is difficult to estimate the effect on investment. Nonetheless, for the moment, it is useful to refer to the last 40 years of peer-reviewed, economic research showing that a higher tax burden will increase the cost of capital and therefore reduce investment (see among others, Auerbach and Hassett, 1992; Bond and Xing, 2015; Chirinko et al, 1999; Cummins et al., 1996; Desai and Goolsbee, 2004; Devereux and Griffith, 2003; Maffini et al., forthcoming; Hall and Jorgenson, 1967). Uncertainty has also been shown to increase the required return to capital and, therefore, reduce the incentive to invest (Bloom et al, 2007; OECD/IMF, 2017) .[2] Should the proposals discussed in the PCD increase the cost of capital through an increased tax burden, investment will be reduced. In this light, policy makers should consider how the proposed measures and their effect on investment interact with the broader macroeconomic environment, especially in the case of a global economic slowdown.

2. *The effect on compliance and administrative costs*. Compliance and administrative costs are thought of being a pure loss for the economic system as they reduce the resources available for investment and, at the same time, they do not translate to more revenues for the government. The proposals risk being characterised by high compliance and administrative costs: they will have to tackle a lot of boundary issues (e.g., scope, definition of users versus customers, definition of marketing towards other intangibles) and may need business to come up with metrics which are subjective and/or not yet robustly produced and understood (e.g., value of users contribution, active versus passive users). Compliance costs will increase further if businesses have to segment metrics by product lines and by country together with the relative costs and revenues. Not only will businesses clearly in the scope have to face compliance and

[2] Bloom, N., S. Bond, and J. van Reenen (2007), "Uncertainty and investment dynamics," Review of Economic Studies. OECD/IMF Report on Tax Certainty - 2017 Update. Link: https://www.oecd.org/tax/tax-policy/tax-certainty-report-oecd-imf-report-g20-finance-ministers-march-2017.pdf

administrative costs but many businesses at the margin will have to invest resources in assessing and possibly proving that they are outside the scope of the new measure.

3. *The effect on tax revenues*. At the moment, there are no indications from the Inclusive Framework of whether the new measures imply an increase or a decrease in tax revenues and which countries will benefit the most. The only study on this issue shows that small, open economies will lose revenues with the proposals currently being considered by the Inclusive Framework (Næss-Schmidt et al., 2019).[3] It is surprising to note that both the marketing intangibles and the user contribution proposal have been put forward without a discussion of their impact on revenues in different countries. The lack of this important assessment makes an overall economic assessment of the proposals difficult.

If the costs arising from 1. (through lower investment) and 2. are not compensated by an increase in revenues (3.), it will be difficult to argue that the new measures increase welfare for the overall economy. We encourage the Inclusive Framework to carry out an analysis of whether the contemplated changes in the system will increase welfare for the overall economy by at least taking investment, compliance costs and revenues into account. Without such an assessment, the benefit of the proposals discussed could be questioned.

[3] Sigurd Næss-Schmidt, Palle Sørensen, Benjamin Barner, Christiansen, Vincenzo Zurzolo, Charlotta Zienau, Jonas Juul Henriksen and Joshua Brown, Future Taxation Of Company Profits: What To Do With Intangibles?, Copenhagen Economics, 2019.

Section 2: Chapter 2 - Profit allocation and nexus proposals

A. Introductory comments on profit allocation and nexus

The PCD refers to the potential reform of nexus and allocation rules. Such references acknowledge that the two sets of rules are interlinked and interdependent and should be reformed together; yet the PCD ascertains that a new policy imperative (albeit lacking consensus) is to attribute greater taxing rights to jurisdictions wherein users (a term which still requires significant clarification) or consumers are located.

For profit allocation, the proposals in the PCD suggest there is openness from countries to moving away from the arm's length principle (ALP) and the single entity approach, either in limited or a broader range of circumstances. To support such potentially far-reaching changes, we encourage the Inclusive Framework to explain why and in which cases the ALP and the single entity approach no longer work. The document contains general but numerous references to the fact that only a modest return may be allocated to LRDs in the market jurisdiction. It is unclear how a relatively minor element of the tax system like the treatment of LRDs can demand such large changes in the system. In addition, the PCD seems to imply that LRDs are in many cases, if not always, part of a contrived structure through which a multinational (MNE) group may artificially seek to reduce the profit allocated to a market jurisdiction. The focus of the PCD seems to be on anti-avoidance without any discussion of the fact that the return allocated to an LRD could be simply the result of an appropriate economic analysis of the activities of the local operations.

At first sight, the current transfer pricing framework may seem to present challenges in moving taxable income to the market jurisdictions. Nonetheless, we believe that there are options which can be simple and, at the same time, that may meet the policy objectives within the ALP, reducing the disruption to the internationally accepted standards. PwC remains open to analyse and discuss those options further and beyond what we describe in this document. The current tight timeframe has not allowed for a thorough, well-considered investigation.

Should the Inclusive Framework decide to move away from the ALP and single entity approach, clear guidance will be required, preferably outlining a flexible and principles based approach, or a detailed and mechanical approach with the view of reducing uncertainty and complexity for all stakeholders (including tax authorities, taxpayers and consultants, but also for tax courts and, as the case may be, arbitration committees). PwC remains open to engage in a discussion of the effects and mechanics of a departure from the ALP and the single entity approach beyond the tight timeframe of the current consultation.

It is also critical with any move away from the ALP that whatever allocation of taxing rights is endorsed is principles based and rooted in agreement on what activities and interactions create value (and how) for an enterprise. A solely political compromise or a purely mechanical approach is unlikely to be sustainable in the medium to long term. Tax rules detached from economic reality have the potential to create an unstable system with no actual limits to claims on the tax base, even in the presence of strong dispute resolution systems, which in practice are often slow and costly for both taxpayers and tax authorities.

A significant challenge with seeking to identify "active" presence without requiring "physical" presence is the reliance for the user participation and marketing intangibles proposals on an assumption that activities must be deemed to take place somewhere where they clearly do not "actively" do so. Even if a sufficient nexus is to be assumed, factors in allocating profit might need to recognise the location from which the activity of promoting user participation is occurring and from where the activity of the creation of a marketing intangible is occurring.

Overall, for the long-term stability of the system, it would be more efficient to first determine a principled framework against which income could be allocated to a country, and *only then* set a nexus threshold that is consistent with these principles and at a level that relieves the administrative burden on taxpayers and tax authorities from merely incidental activity. If there were to be a move away from the ALP and the single entity approach, we recommend a longer period for analysis, discussion and consultation with various stakeholders to arrive at a robust assessment of the implications of the new rules for the tax system, for its administrability and for the incentives of business and governments.

We are mindful that the timetable to which the OECD is working is tight, and accordingly we have outlined considerations that may be useful for the discussion on whether new profit allocation and nexus rules are required.

B. Profit allocation

General

The proposals set forth in the PCD contemplate a departure from the separate entity approach that has been a mainstay of profit allocation rules historically. We have the following initial observations:

1. *Group-wide allocation vs transactional approach*. Dividing profits based on transactions between legal entities - rather than resorting to group-wide allocations - would better align tax consequences to the underlying economics of transactions involving associated enterprises, especially considering that legal entities have real, non-tax significance that impacts how companies do business and bear risks. Analysis of transactions at the legal entity level would also help prevent distortions in allocation of profits among different jurisdictions. For example, consider an MNE that is engaged in significant marketing activities in relation to Countries A, B, and C, but not Country D. The MNE generates significant revenues in Country D, notwithstanding its lack of significant marketing activities in relation to that jurisdiction. If, for example, proposals were to be implemented at the MNE level and, hence, the group expenditure for marketing intangibles was considered (not the expenditure in the local market) with group-wide profits allocated among jurisdictions based upon factors such as revenue, Country D could obtain a right to tax value that, in reality, does not originate in Country D - at least not in the same way or to the same degree as in countries A, B, and C.

2. *Business line approach*. Notably, a similar type of distortion could potentially occur even if the proposals were to be applied on a business line basis, given that differences in market characteristics and business practices across markets could exist within the same business line. While it is less precise than a single-entity approach and still

susceptible to distortions, for MNE groups that operate several business lines, determinations of values on a business line basis may provide better alignment between tax consequences and the underlying activities and economics of an MNE's business, since analysis at the business line level would be more likely to account for different business strategies across different business lines. Nonetheless, for many complex businesses where for example the same investment in infrastructure supports different services, a business line approach could become complex to comply with.

3. *Modified separate entity approach*. It may be possible to adopt modifications to the current international framework, while also retaining the separate entity framework for the purposes of determining the precise tax consequences of transactions between associated enterprises. For example, rather than identifying value at the group level and allocating to different jurisdictions, a Residual Profit Split Methodology (RPSM) approach could be used to identify value in a transaction between a Country A principal company (performing all DEMPE functions) and a Country B distribution or other entity, with taxing rights to some portion of residual profit being assigned to Country B notwithstanding the absence of non-routine DEMPE functions in Country B.

4. *Effectiveness of apportionment methods*. Overall, the continued effectiveness of apportionment methods as a tool for minimising disputes would depend on relative stability in the relationships and approaches among jurisdictions, and the continued validity of the underlying bases upon which countries arrive at consensus as part of the current process. Formalisation of the agreement of jurisdictions to abide by apportionment methods will also likely be necessary to ensure the long-term viability of apportionment methods as a tool for minimising tax controversies between jurisdictions, and any such formal agreements should be designed in a way that limits the ability of individual jurisdictions to act unilaterally in contravention of the accepted international consensus. If a fixed allocation metric is introduced, we encourage the Inclusive Framework to investigate which system would set the right incentives for all jurisdictions to respect the agreed metric. Without the right incentives in place, many observers fear the system would quickly evolve in a larger and larger allocation of a group's income to the markets. Such system will have to be easily administrable, simple and support tax certainty.

We consider below in more detail the pros and cons of approaches based on RPSM or fractional apportionment.

The residual profit split method (RPSM)

Since their acceptance as recognised methods in the OECD TPG in 1995, the profit split methods have played a useful role in Advance Pricing Agreements (APAs) and in the circumstances indicated in the OECD TPG, i.e., when each party makes a unique and valuable contribution in a highly integrated business activity. Nonetheless, profit splits remain a relatively infrequently used method.

After the publication of the PCD, PwC undertook a short survey on the use of profit splits among a number of our Network Member Firms. The survey was intended to identify the main issues encountered across our network with respect to profit split methods. Given the short timeframe, however, the survey was not intended to derive statistically relevant evidence on the use of profit

split methods. Its results are described in more detail in Appendix 2. Here we summarise some key points:

1. *Current usage of the method*. Profit split methods are not widely used and represent between 1% and 15% of the overall cases seen in our network, with the large majority of countries reporting a share between zero and 5%. Although their use is concentrated in the better resourced economies, profit split methods remain a minority method, including in G7 countries. Some G24 countries report that they have never used profit splits.

2. *Effect on certainty*. Profit splits can give rise to uncertainty for both business and tax authorities. This is due to the fact that the calculation and allocation of routine and non-routine returns across different entities is often challenging and can be perceived as subjective.

3. *Compliance and administrative costs*. To support profit splits, taxpayers may need to collect a large amount of information across some entities of the group. The burden will increase if profit splits are applied on a product-by-product and country-by-country basis and, additionally, if information has to be sourced throughout the whole group, as the PCD seems to suggest. It is not by chance that profit splits are slightly more common in the financial industry where branches often already possess adequate information because of the regulatory requirement of their industry.

4. *A small number of entities*. Most profit splits our network firms have seen are confined to two principal entities. Only four of the surveyed jurisdictions reported profit splits experiences that include three or four entities. In practice, profit splits are not used to allocate profits in a group-wide transfer pricing exercise.

5. *APAs, Mutual Agreement Procedures (MAPs) and audits*. In many cases, although not all, profit splits are carried out within the framework of an APA, an audit or a MAP case and therefore, in close interaction with the tax authority.

    - Given the aforementioned challenges, it is unclear whether it is expedient to pursue a RPSM for implementing a completely new system of taxing corporate income whether it is under the user contribution or the marketing intangibles proposal. Given the identified challenges of profit split methods, we encourage the Inclusive Framework to also investigate alternative approaches under the ALP which could achieve the same objectives as the type of RPSM described in the PCD. PwC remains open to discuss these approaches beyond the tight timeframe of the current consultation.

Should the Inclusive Framework decide to adopt RPSMs to allocate more income to market jurisdictions, some technical issues should be clarified with the aim to resolve uncertainty and reduce complexity. The description, approach and application detailed in the PCD for a RPSM is different from the description, approach and application of profit splits under the Revised

Guidance on the Application of the Transactional Profit Split Method (June 2018) (Revised Guidance).[4] In particular,

1. *Unique and valuable contributions*. The Revised Guidance states that profit splits should be used when each party makes unique and valuable contributions, the business operations are highly integrated such that the contributions of the parties cannot be separated from each other and finally, the parties share the assumption of economically significant risks, or separately assume closely related risks. The profit split approaches of the PCD seem to be suggested for very different circumstances where third parties are possibly involved in the creation of value for the enterprise or group (user contribution proposal) or marketing intangibles are created by the business and used/taxed in a market jurisdiction because of their intrinsic connection with the customers, a third party.

    - The discussion of profit splits in the context of the PCD seems detached from the principles outlined in the 2018 Revised Guidance and based more on a desire to find a relatively simple way to allocate income in a very new situation, i.e., the allocation of income to a jurisdiction where there is no nexus or nexus is essentially related to the existence of a third party. If the RPSM described in the PCD is adopted, we encourage the Inclusive Framework to discuss its relationship with profit splits as described in the 2018 Guidance.

2. *Transactional versus default method*. Where the OECD TPG (including the Revised Guidance) advocate a transactional approach based on the most appropriate method to the circumstances of the case (the analysis leads to the selection of the method), the PCD starts from the RPSM as the default method.

    - Does this imply that for MNE groups within the scope of the new measures, the RPSM will become the only applicable method?

    - The PCD does not recognise the fact that the use of the RPSM may not always be the most appropriate method. For example, the PCD seems to start from the premise that user participation and marketing intangibles would always be a valuable and unique contribution which would warrant the use of a RPSM. It does not, however, consider that user contribution may not have value.

    - More flexibility is needed as digitalised businesses themselves are very diverse: in view of the fact that user participation and marketing intangibles may or may not add to substantial value, it might be better to use a one-sided method, for example when it is clear that user contribution is added. Which contribution is to be the tested one in such analyses would depend on the relevant facts and circumstances.

3. *Meaning of routine versus non-routine profit*. The terms 'routine profit' and 'non-routine profit' should be clearly defined, as they are different from the term 'basic return' used in the Revised Guidance. In the PCD, the term routine profit seems to be

[4] The Revised Guidance deletes and replaces Section C of Part III, Chapter II of the 2017 OECD TPG.

associated with the notion of simplicity and low value activities while the term non-routine profit seems to be associated with complexity and high value activities. The reality of business can be very different from this simplified approach. In particular, routine activities could generate substantial value and income while non-routine activities could be unique but, at the same time, generate little or no value. For example, customer databases and data gathering activities may very well be part of the routine contribution of an entity to a business activity.

- We invite the Inclusive Framework to investigate the characteristics of routine and non-routine profits with a robust economic analysis, should RPSM become the method of choice.

4. *Transactional versus formulary approaches*. Instead of a transactional RPSM, as advocated by the Revised Guidance, the PCD seems to introduce a formulary method. There is no discussion in the PCD of the important drawbacks of formulary approaches: they rely on arbitrarily determined allocation as they ignore differences in factor productivity and hence lead to arbitrary results and consequent uncertainty. In addition, they can distort real economic decisions: companies will have an incentive to move investment and labour to lower tax jurisdictions if taxable income is allocated where physical assets or employment are located, creating further dissatisfaction within some countries of the Inclusive Framework (Fuest, 2008). Practical experience also shows that, because jurisdictions will compete to attract investment and labour, formulary based systems tend to evolve towards a one component formula whereby sales drive most of the profit allocation (Hellerstein, 2014 and Smart, 2018).[5] Rather than abandoning significant aspects of the existing international tax framework and moving to using formulary approaches which will raise challenges for both large and small economies, PwC strongly believes that the solution should first be sought in the correct application of the internationally agreed ALP, with consideration of adjustments for the objectives of the Inclusive Framework.

   - Because one approach will likely not be appropriate for all enterprises, if the Inclusive Framework decides to adopt a type of formulary method, its application should be subject to an opt-out or rebuttable presumption that would allow both tax authorities and taxpayers to demonstrate why the formulary approach is not appropriate in their case.

   - Should the Inclusive Framework decide to implement a formulary method, it should be clarified whether such formulary method would be intended for purely domestic (unilateral) application, or whether a more global formulary method is envisaged. Under either approach, mechanisms would need to be in place to ensure that formulary methods are consistently applied across different countries in a manner that prevents double taxation. This would include eliminating mismatches between countries in terms of the parameters and application of formulary methods used, as well as ensuring that individual

[5] Hellerstein, W. (2014) 'Designing the Limits of Formulary Income Attribution Regimes: Lessons from the US States and the Proposed EU CCCTB', State Tax Notes 72: 45. Michael Smart, "Corporate income tax sharing: The Canadian way", Presentation given at the IMF COnference "Splitting the Riches: The Present and Future of Taxation by Formula", April 2018. Link: file:///C:/Users/950551/Downloads/session-22-michael-smart.pdf

jurisdictions do not, in practice, diverge from the internationally agreed approach.

In paragraph 24 of the PCD, the intended profit split approach is described as involving four steps. The third step should only refer to an allocation of a proportion of the residual profit; otherwise other high value or unique contributions (or highly integrated operations or shared assumption of risk or separate assumption of related risk) not related to the digitised business could no longer be remunerated.

It would also seem that the PCD suggests that user participation could be regarded as a (valuable and unique) intangible. One could question whether it meets the already very broad definition of an intangible for transfer pricing purposes: something which is not a physical asset nor a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. Insofar as one can try to link or persuade a user to participate, but can never own or control that user to make them actually participate, it is clear that this does not meet the current definition of an intangible. One might usually consider user participation rather as a comparability factor (a client or user attachment) than an intangible. In that case it would more normally be considered in the analysis leading to the selection and application of the method (which can either be a one sided method or a PSM) and an adjusted approach would be necessary. Care should be taken in amending the definition of core concepts, however - assets (intangible or otherwise) being controlled by an enterprise is a key concept underpinning a number of legal, accounting, and tax systems. There may be merit in seeking alternative ways to include these concepts without disturbing existing concepts.

Fractional Apportionment

The PCD indicates that fractional apportionment is contemplated not only by the Significant Economic Presence proposal[6] but also by the user contribution and marketing intangibles proposals.[7]

1. *Objective vs subjective determinations*. Although use of fractional apportionment methods may appear to provide a practical basis for division of profits among different jurisdictions, it is important to recognise that subjective determinations will be a factor in how apportionment methods would need to be tailored and applied. Establishing clarity in application at the outset will be critical for any administrative benefits associated with adoption of fractional apportionment to be realised; however, clarity in application should not come at the expense of principled tax administration that takes into account the facts and circumstances of an MNE group.

2. *Distortive effects and potential shortcomings*. It is recognised that formulary based apportionments of profit are commonplace in transfer pricing implementation and that their use can often offer a practical and reasonable means of determining the arm's length results of related-party transactions. However, the use of a reasonable allocation mechanism that has a relationship to a particular transaction (or set of transactions) in

[6] See PCD at Paragraph 56.

[7] See, e.g., PCD at Paragraph 24 (noting that the User Contribution Proposal would allocate profits between jurisdictions based on an agreed allocation metric) and Paragraph 47 (referring to "mechanical approximations" and "formulaic approaches" in discussing how income may be allocated in the context of the Marketing Intangibles proposal).

a particular analysis is not the same as using a fractional apportionment approach to divide and assign profits of a global group amongst different jurisdictions. Indeed, use of fractional apportionment or mechanical allocation methods at the global group level runs the risk of divorcing taxation from the economics of the underlying transactions among associated enterprises and is potentially fraught with problems that the OECD has acknowledged within the last five years. The 2017 OECD TPG noted the potentially distortive effects that can occur when transfer pricing rules fail to account for market forces and the ALP.[8] Further, the 2017 OECD TPG identified a number of shortcomings of formulary apportionment approaches, including that predetermined formulae are arbitrary and disregard market conditions, the particular circumstances of individual enterprises, and management allocations of resources, and can result in potential exchange rate complications, among others.[9]

3. *Market and economic circumstances*. In the event that fractional apportionment methods are adopted, their use should be limited as much as possible in order to minimise disparate treatment between the results of the fractional apportionment approach and the results that would occur under the prevailing transfer pricing framework (including the DEMPE framework contained in the 2017 OECD TPG). The mechanics of any fractional apportionment methods would need to take into account market circumstances and the economic circumstances of the taxpayers involved in the relevant transactions in order to align taxation outcomes and economic outcomes. This includes consideration of the economics of different businesses (e.g., those with higher or lower profit margins, those that rely more heavily on marketing intangibles), which may require different approaches to different business lines within a single MNE. The methods would need to also account for variations in the company's profile across jurisdictions (e.g., a company may be a well-established market participant in one jurisdiction, but a new entrant in another) and market differences (e.g., maturity of market for product across jurisdictions, or differences in sales channels for the company's products with a direct effect on the importance of brand in driving value), rather than using metrics that may not be indicative of value. Additionally, the methods would need to consider potential changes in market conditions over time, and should not use arbitrary, inflexible allocation keys to determine either the value subject to tax (e.g., treating a fixed percentage of system profit as "user contribution value") or the location of taxation.

4. *Comparisons between markets*. The example in Table 1 illustrates how, under a fixed metric detached from value, two very different markets could be allocated the same income (here we assume 2% return on sales). Company XYZ sells similar products in A and B. In market A, the price is much lower, for example because of very little marketing activity, intense competition and/or lower customers' purchasing power. A lower price implies a lower profit margin (20% in A versus 91% in B), despite a much larger volume. Assuming an allocation of intangibles value based on revenue and a 2% return on sales to each of markets A and B, both jurisdictions are allocated the same income (20). This result indicates that the same allocation is awarded to two very different markets in

[8] See Paragraph 1.3 ("When transfer pricing does not reflect market forces and the arm's length principle, the tax liabilities of the associated enterprises and the tax revenues of the host countries could be distorted.")
[9] See Paragraphs 1.25, et seq.

which the business is likely to make very different levels of investment. This happens because a fixed metric is detached from local profitability leading to results contrasting with the principles advocated for the marketing intangibles and the user contribution proposals, i.e., recognising the different levels of interaction between the market (or users) and the business. In this example, if the higher unitary costs in B reflect higher marketing costs and/or higher investment of the business in the market, such higher marketing or investment costs are not reflected in the allocation because A and B get the same allocation under a fixed allocation metric.

Table 1. Profit allocation in markets with different characteristics.

Country	Revenue	Unitary Price	Volume	Unit cost	Total costs	Profit	Local profit margin	Allocation to market (2% ROS)
A	1,000	1	1,000	0.8	800	200	20%	20
B	1,000	10	100	0.9	90	910	91%	20

5. *Competition and disputes*. Adoption of a fractional apportionment approach could (assuming that the formula and base is included in ways that cannot be overridden by domestic law or tax authorities' interpretations) potentially reduce disputes between tax authorities over the amounts each jurisdiction is entitled to tax, as well as disputes over the value of user contribution or marketing intangibles (which would be subject to tax in the market jurisdiction) relative to other intangibles (which may not be subject to tax in the market jurisdiction). Nonetheless, an unprincipled, fixed allocation metric could be vulnerable to claims from more aggressive jurisdictions. For example, an unprincipled 2% return on sales disjoint from the analysis of the value of the business and its economic fundamentals could easily be challenged as being too low and, consequently increased to any positive level, given its lack of a strong economic basis. The incentives to overclaim for some jurisdictions would increase if the new fractional approach does not allocate losses to the market jurisdiction but only a share of revenue. Overall, the risk is that a practical fractional apportionment is unprincipled if disjoined from value creation and becomes the first step for an expansion of taxing rights of market jurisdictions at the expense of jurisdictions in which DEMPE functions occur or value is created. We invite the Inclusive Framework to consider whether with time and changing economic conditions, such expansion could also go beyond the share of income related to user contribution and marketing intangibles potentially affecting the entire current transfer pricing system, including the arm's length principle. An analysis of the revenue consequences and of the effects on business behaviour of such an expansion would be an important basis for the assessment of the long-term consequences of fractional approaches.

C. Nexus

General

As noted above, we believe that it would be more efficient to first determine a principled framework against which income could be allocated to a country, and only then set a nexus threshold that is consistent with these principles and at a level that relieves the administrative burden on taxpayers and tax authorities from merely incidental activity.

The user participation model appears to place considerable emphasis on users (and user interaction) as the driver in value creation for some business models, but not others. If interaction with users can create value for an enterprise, it is not coherent that this could be a key driver of value creation for some businesses, but not for others. The interaction with other factors in the value creation process (e.g. data curation, analytics, algorithms and platform development, etc) will differ between businesses and industries.

The marketing intangibles approach recognises that there may be a complex mix of multiple drivers in the value creation process and that the market location may be integral to the development of value in a wide range of businesses, but it does not provide sufficient clarity on why this relates specifically or solely to marketing intangibles.

The significant economic presence proposal outlines more detail than the preceding two proposals on what an appropriate nexus threshold might be, although this is only possible because the objective of the profit allocation proposal is so much more developed - the objective appears to be to allocate a portion of taxable income to all countries to which an MNE makes sales (the other factors appearing only to be a benchmark against which incidental sales - i.e. sales that were not directly sought - are excluded). We therefore believe that to rely on the nexus proposals outlined under the significant economic presence proposal could present some important challenges mainly due to the fact that the only related, coherent profit allocation method would be a fractional/ formulary apportionment. As we explain below, fractional/ formulary apportionment is not grounded in the concept of value creation and could lead to distortions in the tax system, in the economy and significantly affect the revenues of the countries of the Inclusive Framework. Further, if the significant economic presence model is adopted (whether stand-alone or in conjunction with another model), there should be a materiality threshold so that only a meaningful participation in a source country's economic life should result in taxation exposure there.

We are mindful that the timetable to which the OECD is working is tight, and accordingly we have outlined considerations that may be useful in defining nexus thresholds within the context of the PCD's questions, as a separate subsection within this response. We would welcome further opportunities to provide input into appropriate thresholds when the principles against which income will be allocated are more fully formed and agreed.

Broader economic considerations and the incentives that thresholds pose must also be considered. The PCD and OECD Interim Report on the Tax Challenges of the Digitalisation of the Economy both note that as a result of BEPS Actions 7 and 8-10, some groups have responded by on-shoring assets and changed distribution models to "justify only minimal tax in

the market jurisdiction". The potential incentives for such restructuring in light of the revised thresholds should be considered against the broader economic and policy objectives.

Key design considerations

During the BEPS Project, many businesses noted concerns that lowering the threshold at which an enterprise would have a permanent establishment in a state could result in the proliferation of permanent establishments. The burden of complying with corporate tax obligations once a permanent establishment (or other taxable presence) is asserted can be extensive, including (for example):

- Filing tax returns
- Preparing, auditing, and filing local accounts
- Tax advisory costs
- Book-keeping
- Invoicing obligations
- Other legal obligations (e.g. mandatory reporting regimes)
- VAT or other tax filing and compliance obligations
- Systems costs (related and unrelated to the preceding points)

Businesses (especially small and medium sized enterprises seeking to exploit new markets) may conclude the benefit is not worth the administrative costs (and potential tax cost, or double taxation risks). Decisions to limit exposure will impact local employment and investment (and even if the nexus threshold applied factors other than real investment in a market, access of local businesses and citizens to goods and services may be limited).

Appropriate level

It is therefore critical that the threshold is set high enough as to encourage cross border trade and growth. It is unlikely that thresholds set on fixed amounts of revenue, users, or other factors would be suitable for all industries (with different profit margins, for example). Instead, a threshold based on the *degree* of interaction must be established. The pre-BEPS permanent establishment threshold was favoured by businesses because it contained "bright line" tests that were principles-based and clear. Any new thresholds should follow this concept (especially if they relate to a broader interaction than a business could seek to avoid by moving the location of its assets).

This project clearly has different objectives to Action 7 of the BEPS Project; the proposals are not seeking to limit the "artificial avoidance" of existing permanent establishment thresholds, rather they seek to establish a new threshold - presumably not to be based on the location of fixed places of business or location of an enterprises' agents. A key design consideration will be whether this is achieved through amending existing permanent establishment thresholds (OECD Model Tax Convention Article 5, either through amendment or a new paragraph) or creating a corresponding new threshold that sits alongside the existing permanent establishment thresholds. This decision will be influenced by the practical challenges of whatever profit allocation standards are agreed (and whether they are consistent with Article 7 on the attribution of Business Profits - either through amended guidance or amended treaty

language - or an additional treaty article is required to accommodate the revised attribution rules).

Finally the threshold must be clearly and consistently applied. Strong and clear guidance must be agreed alongside the proposals.

Interaction with existing thresholds

It will be critical to ensure that whichever option is selected, this can (i) coherently sit alongside the existing permanent establishment thresholds on an entity by entity basis, and (ii) coherently tax the activities of different entities (potentially related or unrelated enterprises). These challenges relate both to the thresholds working together to ensure the appropriate rights to tax are granted to the "source" state, and also that they are not both simultaneously triggered in relation to the same profits without an ordering mechanism in place to relieve double taxation. A significant challenge under the BEPS Action 7 work on profit attribution was that the same economic profits could have been allocated to a resident company (the so-called Dependent Agent Enterprise, or DAE) and a permanent establishment of a foreign company (the so-called Dependent Agent Permanent Establishment or DAPE). Similar challenges could be addressed up front by designing the threshold in a coherent manner, and if required making corresponding changes to other areas of the relevant bilateral tax treaty simultaneously.

An additional complication that may also influence this decision is that a number of countries have opted not to apply the revised Article 5 in their treaties. Accordingly, any solution that sits alongside or within Article 5 must either mandate a single agreed Article 5, or accommodate both pre-BEPS and post-BEPS Article 5 permanent establishment thresholds.

The complexities here further reiterate the need for strong, effective, and efficient dispute resolution mechanisms to be included simultaneously (see our comments above in relation to this point).

Application to specific PCD proposals

All three proposals stated their purpose to address the policy goal of taxing income where it is sourced (i.e. value where it is produced). The "user participation" proposal limits itself to certain business models (social media, search engines, online marketplaces), "ring-fencing" a sliver of the overall digitalising economy, while the "marketing intangibles" and "significant economic presence" proposal would have a wider application. In that context the following comments may be useful.

User contribution

1. *Two main premises*. The first is that value is created in the jurisdiction of the users and customers through their engagement with the business and/or its platform. The second is that the value arising from the users is currently not being (or has not been) taxed in the jurisdiction where it arises, i.e., in the market where the users are located.

2. *What to tax and how*. Since customers and users are third parties to a business, there is no broad agreement on whether the value they create constitutes value created by the

enterprise, value created by the users or customers, or value created symbiotically through their interactions. Consequently, there is no agreement on whether returns allegedly related to such value should be taxed under the corporate income tax regime, and if so, how much of it. It seems logical to argue that, if the value is not created by the enterprise but by third parties, tax authorities may want to tax using, for example VAT (or other consumer taxes). Given the uncertainty around the first premise, it will be difficult to establish whether returns allegedly related to such value should be taxed where the users/customers are located.

3. *How digitalised would a business have to be?* At first glance, the proposal focuses on highly digitalised businesses and, therefore, it seems to be the narrowest of the three proposals under Chapter 2 of the PCD. Nonetheless, digitalisation means that more and more businesses can reach their customers directly, without intermediaries, and interact with them to improve the offering of the company's existing products and services, implying that more and more businesses could have users or active users in the future. This transformation also blurs the boundaries between B2B and B2C businesses. It is therefore unclear whether the user participation proposal will remain ring-fenced as suggested in paragraph 21. We encourage the Inclusive Framework to assess the scope of the user participation proposal for the next decades against the broader business trends driven by digitalisation whereby the interaction of traditional businesses with their final customers will become easier and more commonplace.[10]

4. *Definitions*. For a proposal that inherently ring-fences specific types of businesses, the PCD OECD note seems to suggest the scope will be defined with reference to some business models: social media platforms, search engines, and online marketplaces [para 19 and 28]. As noted above, more and more traditional businesses improve their offering by bundling together their traditional products and services with platforms where customers can discuss and improve such products and services. Such platforms may resemble a social media. Similar examples arise in search engines and marketplaces too. Overall, the scope of the measures is at risk of becoming larger and larger as the economy continues to digitalise and traditional businesses implement new, digital ways of doing business. This trend not only blurs the difference between highly digitalised, user-intense business and traditional companies but also the difference between B2B and B2C business. In addition, a scope defined upon evolving business models will create a lot of uncertainty for both businesses and tax authorities as companies cross the uncertain threshold between traditional and more highly digitised activities, between B2B and B2C businesses.

Marketing intangibles

1. *Active intervention*. The marketing intangibles proposal states that it is intended to apply to firms that are engaged in "active intervention" in markets. It is unclear whether such "active intervention" exists only based upon activities of a business that targets customers in a particular jurisdiction. Alternatively, could a business be treated as

[10] https://www.pwc.com/gx/en/industries/industries-4.0/landing-page/industry-4.0-building-your-digital-enterprise-april-2016.pdf

having "active intervention" based on the actions of customers e.g., many customers in a jurisdiction buying a firm's products off its website even though the firm never engaged in marketing or other activities promoting its product in such jurisdiction?

2. *Differential impacts*. The marketing intangibles proposal has a much wider scope that, according to their proponents, is intended to respond to the broader impact of the digitalisation of the economy, while not being specifically limited to digital businesses. Nonetheless, depending on the definition of marketing intangibles, the proposal could end up having more impact on industries with a higher share of marketing intangibles versus other intangibles, such as for example the consumer goods sector.

3. *Intrinsic link to jurisdiction*. The marketing intangibles proposal is a significant departure from existing nexus and profit allocation rules, and is based on the key concept of an "intrinsic functional link" existing between marketing intangibles and the market jurisdiction. This link forms the basis for allocating some or all of the non-routine income associated with marketing intangibles to the market jurisdiction, irrespective of which entity in the MNE group owns legal title to the marketing intangibles, which entities in the group factually perform or control DEMPE functions related to those intangibles, how risks related to the marketing intangibles would be allocated under existing transfer pricing rules, and how those rules would ordinarily allocate income related to the marketing intangibles and their associated risks.

4. *Not just a simple trade vs marketing analysis*. This linkage potentially ignores the fact that there are many drivers of residual profits, not just marketing and trade intangibles; for example, entrepreneurial risks. The assumption and management of supply chain risks such as capacity, input cost variance, operational leverage and quality drives superior (non-routine) returns which are not associated with intangibles. Even if this approach is adopted, the allocation of residual profit should not therefore be driven by a simplistic trade vs marketing contribution analysis. The use of a cost based approach (R&D vs marketing expenditure), mentioned in the PCD, might produce some inconsistent results. For example, such inconsistent results could be found in the case of a trade intangible with a long life, substantial expenses that may not lead to any trade intangibles at all, the creation of an intangible that can be achieved only after a long term investment (e.g., pharmaceutical sector), or expenses that are capitalised versus costs directly considered in the profit and loss account.

5. *Comparison with other demand conditions*. PwC agrees with an observation in the PCD that any additional tax under the marketing intangible proposal should only capture the returns related to the value created by MNEs through the *active intervention of the firm in the market*, and that this is different from favourable demand conditions in the market jurisdiction that exist independent of the actions of the MNE. Thus, it will be important that any proposal provide definitional clarity regarding "active intervention" in a market, and include appropriate minimum or materiality thresholds to address potential compliance and administrative concerns.

Significant economic presence

1. *A move to formulary apportionment*. SEP is effectively a move to formulary apportionment and thus it would be necessary to look at the agreed formula to identify an appropriate threshold. As the PCD points out, revenues alone are unlikely to be an effective and efficient method.

2. *Coherence and consistency*. A formula that can be implemented in a coherent and consistent way may be considered by many stakeholders to have merit despite the fact that it ignores differences in factor productivity.

Section 3: Chapter 3 - Global Anti-Base Erosion Proposal

A. Introductory comments on the global anti-base erosion proposal

The OECD/G20 BEPS Project released 15 final reports in 2015, which are yet to be fully implemented. As such, this new and comprehensive global anti-base erosion proposal seems premature. The importance of Action 11 (Measuring and Monitoring BEPS) is to ensure guidance is not simply promulgated but also to ensure proposed measures are accomplishing stated goals and functioning properly. A more calculated, targeted approach based on empirical data gathered under Action 11 may be more sustainable than drafting and moving ahead on new recommendations while still awaiting outcomes on prior measures.

Within these reports, the OECD/G20 already determined and agreed upon (1) specific measures considered to be harmful and (2) particular structures in which countries have a right to tax income that is otherwise untaxed. Action 5 (Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance) identified specific preferential regimes that were considered to be harmful, as measured by being inconsistent with the nexus approach. A number of no or low tax countries have introduced substance requirements into their regimes since 2015, a clear demonstration of the impact of the BEPS Project. The anticipated outcome of this initiative was to better "align taxation with substance". It is unclear whether any factors have substantially changed to conclude that these regimes, which have since been updated to adhere to the nexus approach, should now be deemed harmful and potentially overridden by the global anti-base erosion proposal in the PCD. The impact would be a limit on governments' ability to use fiscal policy to achieve their economic objectives.

Similarly, Action 2 (Neutralising the Effects of Hybrid Mismatch Arrangements and Action 3 (Designing Effective Controlled Foreign Company Rules) identified specific situations in which countries have the right to tax income that has not already been taxed, namely certain hybrid mismatch arrangements and deferred income of CFCs. The PCD does not set out what new facts or circumstances have been introduced that warrant these guidelines insufficient, which limits the provision of constructive comments.

Nevertheless, we appreciate that many countries believe there are lingering issues from the original BEPS Project and that additional measures are necessary to combat arrangements that result in minimal to zero taxation. The proposals also suggest that some countries believe measures are required to combat BEPS Action 5 nexus compliant regimes that result in lower (but not necessarily minimal or zero) taxation.

Against this backdrop, the PCD introduces two significant measures - a global minimum tax or "income inclusion rule" and two base eroding payment provisions coined the "undertaxed payment rule" and "subject to tax rule". While we understand the general purpose of the base eroding payments rule is to act as a complement to the income inclusion rule, the specific intention of the proposal is unclear. Whether the intention is for this to function as an enforcement mechanism for the income inclusion rule or to serve a separate, stand-alone provision with its own purpose is not stated. We believe the purpose of such a rule should have a large influence on its design.

As noted above, we believe that if initiatives within this domain do garner global agreement, they must address expected design issues and pragmatic reporting concerns. Any solution must include coordination rules between jurisdictions, local country tax regimes, and other PCD proposals to ensure proper allocation and maintenance of taxing rights.

We strongly recommend that the Inclusive Framework strive to retain long-standing and well-founded international tax principles, as in many ways such are still fit for purpose and have been internationally agreed to for decades. We are very concerned that abandonment of these principles may lead to multiple levels of taxation and stifle growth. This may be avoided if the exact same rules are implemented and applied consistently in each jurisdiction, but, as experience teaches, such is highly unlikely in practice. Any variation from these principles, such as diverging from the concepts of value creation and the arm's length principle, risks separating the economics of income generation from taxation.

Our experience is that base eroding payment regimes can cause significant taxation that is not related to solid economic analysis or reasoning. On this front, we believe the U.S.'s BEAT regime denies true economic deductions and raises significant issues. The regime results in arbitrary taxation, which is a severe divergence from the economic reality of the business of the transacting parties. Similarly, in this context, such would be an inherent issue regardless of whether the OECD proposals are implemented on a country-by-country, transaction-by-transaction or entity-by-entity basis.

We strongly encourage the OECD to consider other options that target improper relationships or transactions not economically supported, versus drafting arbitrary rules that simply deny deductions or other benefits because such income is subject to a low rate of tax.

B. Sovereign right to tax and international obligations

The final 2015 OECD/G20 BEPS reports focus on closing gaps between different tax systems to ensure no single jurisdiction uses its tax system to unilaterally erode another's tax base. This reasoning is also inherent in existing CFC-type regimes, where the underlying policy position is that the income subject to the regime is artificially diverted from the tax base of the home country (or an intermediate jurisdiction). This reasoning was further agreed to in the Action 3 and Action 5 final reports - notably Action 5, which outlined ways to eradicate *harmful* tax competition. Counter to that consensus conclusion, the PCD's proposals move toward a system in which countries would be limited in using tax policy to achieve legitimate economic goals. Through such a proposal, the OECD, which has previously applauded the use of tax policy to accomplish such objectives, is fundamentally shifting the conversation to say non-harmful tax competition (i.e., with proper economic substance) is no longer appropriate.[11]

Page 24 of the PCD notes that it is the OECD's intent "to respect the sovereign right of each jurisdiction to set its own tax rates, but reinforces tax sovereignty of all countries to 'tax back'

[11] Angel Gurría, Secretary General of the OECD, congratulated Ireland upon the release of its 2018 Economic Survey, noting the "incredible turnaround" Ireland has experienced since the financial crisis over a decade ago. As documented in the economic analysis, Ireland economic output since the crisis has been stronger than any other OECD country, with the tax policy decisions of Ireland as an undeniable contribution to the success.

profits where other countries have not sufficiently exercised their primary taxing rights". The consequence of this position is to severely limit the impact a tax system can have on economic growth, which we consider a significant departure from the economic theory underlying the current international tax system. In our view, the PCD's proposals risk undermining countries' sovereign rights to use tax policy to promote economic objectives.

The proposal explicitly acknowledges a jurisdiction's sovereign right to tax based on the fiscal and economic goals of such jurisdiction's government. But in addition to setting the tax rate, we also believe defining the income tax base is an inherent right of sovereign nations. Each of these decisions are currently made by reference to the economic policy of the relevant country and allow for non-harmful tax competition across jurisdictions seeking finite resources and investment.

The jurisdictional right to set a tax rate and determine the tax base is a reflection of the economic realities of conducting business in a specific jurisdiction, which is driven by the fiscal prerogatives and choices of the respective jurisdiction. If a jurisdiction has a lower cost of infrastructure, welfare system, or is simply more efficient in delivering government benefits, imposing additional, targeted taxation interferes with what is otherwise an efficient allocation of capital.[12] Different countries take differing views on the role of the state, and correspondingly have differing revenue needs, potentially allowing greater flexibility in setting rates / raising revenue than others. The global anti-base erosion proposal would limit countries' flexibility in these areas, and as such any agreement could be viewed as surrendering a degree of sovereignty. It will be important to such countries that the factors sought under this trade-off (e.g. stability, additional tax revenues) are achieved for the consensus to be sustainable.

We also note that the tax system is but one element countries use to implement fiscal policy, and any proposal that solely focuses on taxation could lead to unintended results. For example, as opposed to offering tax credits or deductions for certain research and development expenses, some countries instead offer (less transparent) cash grants and subsidies (e.g., Germany, the United States, etc.). Alternatively, jurisdictions may attract investment by reducing non-income taxes. It should be noted that jurisdictions frequently invest in capital projects (e.g., new infrastructure and construction), welfare programs (e.g., healthcare), and other incentive packages outside the tax system to attract business and investment.

From an economic perspective, there is little difference between these types of incentives and taxation. As the OECD acknowledges, businesses and governments make economic decisions. But we believe that focusing on effective tax rates ("ETR") is too narrow a view. Focusing only on ETR would result in increasingly complex tax systems with greater uncertainty with differing results. Which leads to the next question of whether this is the only approach or whether potential issues can and should be dealt with more holistically. As outlined in more detail below, there are predictable behavioural responses from both governments and companies, and thus we would encourage proposed solutions be based on a holistic economic analysis and not simply focused on entity-level or country-level ETR.

[12] As an analogy, a "minimum wage" proposal that taxed MNCs to the extent their foreign affiliates paid lower wages abroad than at home would inefficiently distort companies' labor force decisions and would be viewed by economists as improperly protecting domestic workers from foreign competition. A similar concern is raised by the PCD's proposal to impose minimum taxes on income earned by foreign affiliates.

Income inclusion rule

Implicit in any minimum tax system is potential taxation of earnings without what would generally be considered economic nexus. CFC-type rules have traditionally taxed mobile income that had been diverted away from the tax base of the headquartered jurisdiction (or, in many cases, intermediate jurisdictions). The proposed income inclusion rule goes further and ignores any economic connection and simply taxes based on ETR (presumably based on a tax base as defined by the home jurisdiction). The breaking of taxation from underlying economics raises systemic issues and potential for continual retribution between jurisdictions.

We view this proposal as a break from the stated objectives of prior BEPS reports. Under both Action 5 and Actions 8 - 10 (Aligning Transfer Pricing Outcomes with Value Creation), extensive work was performed to ensure taxing rights follow economics and are properly aligned with substance. Further, the changes introduced by BEPS 8 - 10 worked to improve application of transfer pricing principles to ensure outcomes are "aligned with value creation" and "with the economic activity that produced the profits". While we understand gaps in application may remain, we caution against abandoning these principles altogether.

We believe this proposal will affect investment behaviour of MNEs due to differences in regimes, although the extent of such impact may depend on the rate of minimum tax, and whether the regime allows for tax to be “topped up” to a minimum rate or to jurisdictions’ domestic rates. A minimum tax will inevitably influence both investment from and into jurisdictions, including potential redomiciliations and reductions in investment, discussed in more detail below.

We urge the OECD to consider safe harbours that reinforce a country’s right to determine its own tax rate and fiscal objectives. For example, a company with robust and demonstrable substance in a lower-taxed jurisdiction is verifiable evidence that such jurisdiction made a fiscal decision that attracted investment, jobs, infrastructure, etc., which is not the case with the rule as currently drafted and appears to run contrary to the work of the Forum on Harmful Tax Practices and the conclusions of BEPS Action 5.

Ultimately, this leads to the question as to where and why companies invest - which is a much broader discussion outside the confines of this paper. However, most economic analysis would suggest that taxation is but one element of the business decision. Other reasons include infrastructure and skilled workforce, which may put less-developed countries at a competitive disadvantage. They may need to be more creative with their policies to attract people and capital. Similarly, different countries take differing decisions on the role of the state, and correspondingly have differing revenue needs. Some countries may have greater flexibility in setting rates/ raising revenue from different taxes than others.

Tax policy should remain a central consideration of a jurisdiction's fiscal and economic objectives - which that country and its elected officials determine. Governments ceding sovereignty in tax matters should consider at what cost that sovereignty could be regained by future governments. On this point, we would strongly encourage differentiating the manipulation of tax systems without connection to underlying economics (i.e., the purpose of

the BEPS project) from conscious decisions made by both businesses and jurisdictions to attract investment, create jobs, and spur economic growth.

Tax on base eroding payments

Many of the theoretical questions raised above are also applicable in the base eroding payments context. In addition, the subject to tax rule introduces changes to Article 7 of the OECD Model Convention by denying treaty benefits in situations where the payment is not sufficiently taxed in the recipient jurisdiction. From a practical perspective, we believe these proposed changes to this Article need to be analysed to determine whether such an such approach is even feasible without changing national law.

C. Compatibility with bilateral tax treaties

Most bilateral tax treaties (including the OECD Model Tax Convention) include a non-discrimination article (NDA). In addition, many bilateral tax treaties (although not the OECD Model Tax Convention), and other bilateral trade agreements, and World Trade Organisation agreements contain additional restrictions regarding Most Favoured Nation (MFN) treatment.

NDAs will typically seek to ensure that residents of a second contracting states are not treated differently to those established in the first contracting state under domestic law. Where deductions are to be denied for cross-border payments covered by such treaties on the basis of the recipient's tax rate, this would need to be replicated in relation to domestic law payments in order to avoid treaty challenges. While, in theory, countries may not as a policy matter seek to apply a rate to domestic companies lower than they would permit a foreign country to allow, the domestic interactions may be more complex, for example when factors such as fiscal grouping/ loss relief are considered.

MFN clauses ensure that a treaty partner is not treated less advantageously than other treaty partners. A similar difficulty will arise as in relation to NDAs. However, as this cannot be dealt with even through pre-emptive and complex changes to domestic law, this may be more challenging to counteract than NDA challenges. It would require countries' treaties with all relevant partners' to all be changed simultaneously (a feat which even the ambitious and successful Multilateral Instrument was not able to achieve, both in relation to timing and comprehensive jurisdictional coverage), or at least such changes would be ineffective until such time as all relevant treaties have been updated.

D. Compatibility with EU law

With regards to Member States of the EU, legislative measures in the field of direct taxation fall within their own competence. This results from Article 5 of the Treaty on the European Union in connection with Articles 110 to 113 TFEU under which the competences of the EU are governed by the principle of conferral. The EU shall act only within the limits of the competences assigned to it by the Member States in the Treaties to attain the objectives set out therein. Competences not assigned to the Union in the Treaties remain with the Member States. As direct taxes are not listed in Articles 110 to 113 TFEU, they remain at the competence of the Member States (see for example CJEU in *De Groot* (C-385/00), paragraph 75 or in *Ramstedt* (C-422/01), paragraph

25.; this view is also supported by the European Commission*: "First of all, the Commission would point out that, in the absence of Community-wide harmonisation, establishing the rules governing powers of taxation is a matter for the Member States and is covered by the bilateral tax conventions concluded between individual Member States."* See OJ C 320/107 (6.11.1999)).

The CJEU has so far been more lenient with regard to its fundamental freedom scrutiny of European secondary law. Any action taken only at national level of Member States would be at even higher risk of not passing CJEU scrutiny (see *Becker/Englisch*, The German Proposal for an Effective Minimum Tax on MNE Profits). Therefore, in a first step the question is raised whether for the EU-area the OECD proposal on minimum tax can be introduced via the legal tool of an EU directive, which itself must be compatible with the EU's fundamental freedoms.

At first glance, the requirement of a minimum level of taxation significantly limits the sovereign rights of the Member States in the area of direct taxation and therefore it seems that such a step - unless the contractual framework of the EU is changed - is difficult to be achieved via a Directive. This is true insofar as the only legal basis for the Directive in the field of direct taxation is Article 115 TFEU. Secondary legislation in the field of direct taxation is only permissible if the measures directly affect the establishment or functioning of the internal market. Hence, it needs to be established whether the minimum-tax-measures are necessary for the functioning of the internal market. In the case of the EU Anti-Tax Avoidance Directive (ATAD) the prescribed goal was to strengthen the overall resilience of the internal market with respect to cross-border tax avoidance practices. One might take the position that this argument could also be used with regard to the introduction of a minimum tax. However, this argument appears to be true only if the level of minimum tax is set sufficiently low, allowing the assumption that without such a mechanism there would be a serious disruption of the internal market. This seems a high bar in light of *Eurowings (C-294/97)* .

Besides the narrow limits of Article 115 TFEU, the use of Union competences is further governed by the principles of subsidiarity and proportionality. Under the principle of subsidiarity, the EU shall act only if the objectives of the proposed action cannot be sufficiently achieved by the Member States, but could be realised more efficiently at EU level. Under the principle of proportionality, the content and form of EU action shall not exceed what is necessary to achieve the objectives of the Treaties.

According to these principles, the EU has the competence to issue a Directive in the field of direct taxation only if EU legislation is actually necessary, appropriate and proportionate to achieve the objectives pursued. A European goal has to be identified that cannot be achieved via national measures. Many academics already raised serious concerns that the EU Anti-Tax Avoidance Directive was not in line with the principle of subsidiarity. Considering that the introduction of a minimum tax would even go further in potentially undermining the fiscal sovereignty of the Member States, there are strong arguments that a Directive with the envisaged mechanism would infringe the principle mentioned above. These concerns are supported by the fact that regarding the Commission's proposal on the Common Consolidated Corporate Tax Base (CCCTB) many Member States have already submitted Reasoned Opinions to the European Parliament with respect to a possible infringement of the principle of subsidiarity.

Income inclusion rule

Assuming that the envisaged mechanisms within the EU are established under local laws (implementing an EU Directive or without being based on secondary EU Law), it should be considered that the rules must be in line with the EU's fundamental freedoms. Therefore, any income inclusion rules would be allowed under the current CJEU case law only if they (a) are designed in a non-discriminatory way or (b) cover wholly artificial arrangements only.

We base our comments on the OECD proposal under which the income inclusion rule should only apply in case of a significant (e.g. 25%) direct or indirect ownership interest in that company. In the case of a significant direct or indirect participation, the rules will have to be compliant with the freedom of establishment, which applies to intra-EU scenarios only. However, if the holding percentage for the income inclusion rule is set at a lower level, the rules will have to be compliant with the free movement of capital, which covers third country scenarios as well.

Concerning point (a), one might argue that if all Member States adopt the income inclusion rule uniformly and without distinguishing between cross-border and domestic scenarios, no EU law concerns would arise since no room for potential discrimination would remain (unless an argument can be made that applying a foreign minimum tax on an entity by entity basis, without the possibility of consolidation, would be discriminatory). However, this argument applies only if the minimum tax rate for the income inclusion rule is based on nominal tax rates (being respected by all Member States). We understand from the proposal that this is not the case (mechanism based on ETR). This approach would require Member States to convert the income of the foreign subsidiaries or branches by applying domestic tax law and comparing the adjusted tax base to the amount of foreign tax actually paid. The calculation of ETR based on domestic law would then often result in disparities (e.g., due to patent box regimes) leading to scenarios were the income inclusion rule would de facto apply to mainly foreign EU income and therefore resulting in a possible infringement of the freedom of establishment (de facto discrimination, see *Hervis* C-385/12). Such an infringement is permissible only if it is justified by overriding reasons of public interest. It is further necessary that the rule is appropriate to ensure the attainment of the objective thus pursued and that it does not go beyond what is necessary to attain it. Two possible justifications for the income inclusion rule are the need to prevent tax evasion and the balanced allocation of taxing rights between Member States. In that respect, it is settled case-law that any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated cannot by itself authorise that Member State to offset that advantage by less favourable tax treatment of the parent company (see e.g., *Cadbury Schweppes* (C-196/04), paragraph 49 with further references). Also the CJEU has confirmed that any tax advantage resulting from the low taxation in one source Member State cannot be used by another Member State to justify a less favourable tax treatment (see *Eurowings* (C-294/97), paragraph 44). Such compensatory tax arrangements prejudice the very foundations of the single market (see *Eurowings*, paragraph 45).

Furthermore, it must be noted that according to the CJEU the need to prevent the reduction of tax revenues is not a matter of overriding general interest that would justify a restriction on a freedom introduced by the Treaty. It is also apparent from case-law that the mere fact that a

resident company establishes a secondary establishment, such as a subsidiary, in another Member State cannot set up a general presumption of tax evasion and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty (see, to that effect, *ICI* (C-164/96), paragraph 26; *Commission v Belgium* (C-478/98), paragraph 45; and *Commission v France* (C-334/02), paragraph 27).

Summing up, as the case law of the CJEU stands at the moment, the mere fact that a domestic taxpayer is indirectly benefiting from a low(er) foreign ETR is not regarded as abusive, and thus does not justify the inclusion of the income of foreign subsidiaries in the tax base of the parent company. The income inclusion rule therefore has to be limited to wholly artificial arrangements; otherwise, the general inclusion of low taxed foreign income would be at risk of infringing the freedom of establishment. This approach is also reflected in the EU Anti Tax Avoidance Directive (ATAD, 2016/1164) where, for intra EU/EEA-scenarios, application of the CFC rules under Art 7 line 2 is limited to abusive CFC structures (without substantive economic activity arising from genuine arrangements).

Base eroding payments

The arguments outlined above can also be brought forward with respect to the proposed tax on base eroding payments. Assuming that the effective tax rates differ among the Member States, the non-deduction rules are at risk of infringing the fundamental freedoms. Even if the rules are worded in a way that they cover cross-border as well as domestic transactions/ payments equally there is the risk that a de facto discrimination arises. While in a domestic scenario, the rule would have a rather limited scope of application (because usually there will be no undertaxed domestic payments), the rule would mainly target cross-border scenarios. Such a discrimination, in the light of the CJEU's jurisprudence, would then just be compliant with the fundamental freedoms if the non-deduction rule would be limited to wholly artificial arrangements only.

This topic has already been widely discussed in literature concerning comparable rules that are already operated/ planned to be operated within the EU denying the deduction of certain payments to foreign affiliates if the recipient of the income is taxed below a certain level (similar rules exist for the payment of interest and royalties e.g., in Austria, Sweden, Germany). Most experts qualify these rules as not being in line with EUs fundamental freedoms. With regards to the Swedish interest limitation rule, even the European Commission took the initial view that it infringes the freedom of establishment.[13] Similar arguments have been put forward for Austria and Germany.[14]

[13] The European Commission on 26 November 2014 sent a formal notice to the Swedish Government (C(2014) 8699 final, case number 2013/4206) in connection with the Swedish interest deduction limitation rules and their infringement of EU law. The Swedish government responded on 20 February 2015 (Fi2014/4205). It remains to be seen whether the EC will issue a reasoned opinion to the Swedish Government on this matter.
[14] For Germany see Arne Schnitger, *Unionsrechtliche Würdigung der Lizenzschranke gem § 4j EStG*, DB 2018, 147; for Austria see Richard Jerabek/Nikolaus Neubauer, *Ist die Nichtabzugsfähigkeit von Zinsen und Lizenzgebühren nach § 12 KStG unionsrechtswidrig*? SWI 2014, 369.

E. Double taxation: some specific challenges

In addition to our broader comments around double taxation (and potential resolution thereof) above regarding all four proposals under the PCD, the global anti-base erosion proposal poses some additional specific challenges.

We welcome the OECD's request to develop an ordering mechanism with respect to these proposals and strongly advise the pursuit of a clear and practical rule coordinating between differing initiatives and jurisdictions, and interaction with existing bilateral treaties (which may not be effective when seeking to resolve disputes among multiple territories). Improper application and ordering could result in taxation on several levels, as outlined in more detail below.

Income inclusion rule

The detailed design of the income inclusion rule must include a mechanism to alleviate the burden of potential double (or greater) taxation. In this respect, we welcome the proposal to allow foreign tax credits to offset the inclusion. To avoid double taxation most effectively, the policy should allow for offset by 100 percent of the foreign taxes paid. Further, use of credits should not be limited to the current year (e.g., use of carryforwards) and should not include indirect offsets (e.g., no apportionment of expenses borne by other parties). Absent such an approach, there is a significant risk that even income that is taxed well above the minimum rate could give rise to incremental taxation under the income inclusion rule.

This issue is demonstrated on a practical level by the United States' enactment of the Global Intangible Low-taxed Income ("GILTI") regime. Under GILTI, taxpayers are required under proposed regulations to apportion interest, research, and stewardship expenses to GILTI income to determine the respective foreign tax credit limitation (i.e., the amount of foreign credits that may be used to offset the potential U.S. tax liability). In practice, the methodology has resulted in nearly all U.S. MNEs paying some level of U.S. tax on GILTI earnings, even MNEs that have foreign ETRs greater than the full U.S. statutory rate.[15]

At an even more basic level, any global minimum tax is nearly impossible to design without some double taxation. The PCD suggests that the domestic tax base should be used in calculating the income includable and respective ETR. However, this will undoubtedly lead to double taxation based on different jurisdictions and their mechanics for determining taxable income. Even if a standard tax base were outlined for purposes of the rule, we would still expect inherent potential for double taxation as rules are seldom implemented the same in practice.[16]

---

[15] Richard Rubin, *New Tax on Overseas Earnings Hits Unintended Targets*, Wall Street Journal, Mar. 26,2018, https://www.wsj.com/articles/new-tax-on-overseas-earnings-hits-unintended-targets-1522056600.

[16] Local country enactment of the BEPS Actions has clearly demonstrated the practical issues around implementation, as shown by divergences in implementation of Action 13 (*Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*), leaps forward in approach by the U.K.'s diverted profits tax in the context of Action 7 (*Preventing the Artificial Avoidance of Permanent Establishment Status*), and complete disregard by the U.S.'s enactment of BEAT regarding Actions 8 - 10 (*Aligning Transfer Pricing Outcomes with Value Creation*). Local countries have shown that identical implementation is not possible on a practical level, as most jurisdictions are required to enact such changes into local statute by way of a legislative process. Such differences are problematic enough in a reporting context, e.g., Action 13, but even more so in an area where divergences result in true economic double taxation without remedy.

While a foreign tax credit may partially alleviate potential double taxation (subject to certain parameters noted above), in reality such is nearly impossible to entirely eliminate. This issue and concern is not even limited to regimes and definitions across tax borders. The GILTI regime ushered in a new concept for determining earnings of foreign subsidiaries - known as "tested income". However, this concept diverges from the traditional concept of earnings and profits used for purposes of the remainder of the U.S.'s foreign tax regime, notably the U.S.'s historic CFC rules (known as the "Subpart F regime").

Allocating taxes and income between jurisdictions on an annual basis can also be problematic, due to timing differences, withholding taxes, and other discrepancies between the tax base and taxpayer. We suggest the OECD consider an extended measurement period for calculating ETR and other safeguards, including uninhibited carryover of excess foreign tax credits to subsequent years. Such measures would alleviate potentially bizarre results that can occur on a yearly basis (e.g., through settlements with local tax authorities or otherwise). Similarly, the treatment of losses should be addressed, both current losses and loss carryforwards that may be used in later tax years.

A simple example can illustrate this common issue. Assume a corporation loses EUR 50 in year 1 and earns EUR 50 in year 2. If the local regime provides a carryforward of the EUR 50 loss from year 1 to year 2, the net income subject to tax in year 2 would be zero - resulting in no corporate income tax liability. However, if the income inclusion regime simply determines income on an annual basis - it would view the EUR 50 income in year 2 as taxed at a zero rate - whereas the underlying economics are clear that the company did not earn any income on a net basis.

In addition to losses, there is also risk of taxing income that should not be included in the tax base in the first place. For example, we believe the proposal should consider an exemption for intra-group dividends, similar to the U.S. GILTI regime, and other previously taxed payments to avoid duplicative taxation. In this context, the interaction of the income inclusion rule with the base eroding payment proposal would be critical.[17] It is also important to note that these measures will inevitably add complexity and compliance burdens.

Further, clear coordination/priority rules are needed to ensure the income inclusion rule is only applied once and properly interacts with existing regimes (e.g., CFC rules). Absent such a distinction, the same income could be taxed through several tiers of ownership. For example, if a corporation is subject to an ETR below the minimum tax rate, the income inclusion rule may provide for taxation of that income in the direct parent's jurisdiction, the jurisdiction of its direct parent's parent, and so on. This potential for cascading taxation across multiple tiers and jurisdictions culminates at the ultimate parent. As such, we believe the OECD should consider jurisdictional priority at the ultimate parent level - versus drafting other remediation methods that interact at the lower-tier.

The PCD proposal suggests that the income inclusion rule be applied at the country level but does not preclude the potential for such rule also to apply at the entity level. In our view, if such

[17] For example, the deduction for a royalty payment to a foreign affiliate in a patent box jurisdiction may be disallowed under the base eroding payment rule while the royalty income is taxed a second time under the income inclusion rule of the home country.

a rule were to be agreed on an international level, the version that would best avoid potential design issues and double taxation would be applying such rule at an aggregate level (i.e., aggregating earnings and taxes of all foreign subsidiaries). However, it is worth noting that even the aggregate approach can result in double taxation depending on the system design. For example, and as outlined above, by operation of the U.S. expense apportionment rules, income is commonly subject to additional taxation under the GILTI regime even if taxed at greater than the "minimum" 13.125%. In section G below, we outline additional reasons why an aggregate approach would be preferred over country-by-country or entity-by-entity mechanics.

The public consultation document specifically requests feedback on the respective tax rate to be used for the inclusion of earnings deemed to be taxed below the minimum rate. In this respect we note that using the full domestic rate, as opposed to the minimum rate, will create potential for increased double taxation as well as competitive disparity. On the former, such an approach could lead to multiple levels of taxation if the top tier country rate were higher than the lower tiers (assuming an ordering rule based on direct ownership, versus ultimately parent, is included in the final proposal).

Further, if such income is subject to taxation at the full domestic rate, we expect MNE behaviour responses, including redomiciliations and reductions to investment, as well as corresponding actions by countries, such as lowering corporate rates to the minimum rate to attract business headquarters. In our view, both potential consequences run counter to the objectives of this initiative.

The potential company reaction is not a hypothetical issue and is best shown by the historic experience of the United Kingdom. Earlier this century, the U.K. had a relatively high corporate tax rate and CFC rules viewed by many as complicated and burdensome. Consequently, as the New York Times noted in 2008, U.K. MNEs were "fleeing the tax system" in significant numbers.[18] This phenomenon and related action by the U.K. government was analysed by the Tax Foundation in a 2014 article.[19] In response the U.K. lowered its tax rate and transitioned to a more modern territorial-based system of taxation with more limited CFC rules, and, as a result, stemmed the expatriation of U.K.-based MNEs.

Any CFC-type regime runs the risk of double taxation inherently, as income outside the border of the country with the regime is being targeted. As noted above, this concern must be addressed at the most basic level when designing the respective ETR test, tax base, and related safeguards. It must also address interactions with existing regimes, as well as new regimes, for example, the newly offered proposals to tax base eroding payments.

Tax on base eroding payments

In general, to properly evaluate the design of the tax on base erosion payments, we believe the purpose of the base erosion payment rule should be clarified. It is unclear in the proposal whether the intention is to address inbound base erosion or discipline countries that do not

[18] Julia Werdigier, *British Companies Emigrating Over Taxes*, New York Times, Sept. 4, 2008, http://www.nytimes.com/2008/09/05/business/worldbusiness/05tax.html.
[19] William McBride, *Tax Reform in the UK Reversed the Tide of Corporate Tax Inversions*, Tax Foundation, Oct. 2014, https://files.taxfoundation.org/legacy/docs/TaxFoundation_FF442.pdf.

adhere to an income inclusion rule. Additionally, the interaction of the undertaxed payments rule and subject to tax rule poses different challenges depending on whether the intention is to deny both deductions and reduced treaty withholding rates or use the treaty provisions as a stopping mechanism. Further, it should be clarified whether the initiative is focused on related party payments and associated abuses or intended to be a mechanism to drive larger minimum tax goals.

In coordinating the tax on base eroding payments, including the undertaxed payments rule and subject to tax rule, we suggest the OECD determine and review all coordination rules available, including the primary and secondary approach of the 2015 final BEPS Action 2 Report (Neutralising the Effects of the Hybrid Mismatch Arrangements). Currently, it is difficult to assess the success of the Action 2 approach as we do not have much practical experience with application of the rule, because such measures are only now being implemented across the globe. We note that the base eroding payment element of this section is designed similarly to the Action 2 hybrid rules. However, those rules were designed to encourage taxpayers to eliminate hybrids in the system and did not require extensive coordination between jurisdictions. They also were not designed with the objective of preventing double non-taxation rather than imposing a minimum level of taxation.

Minimising double taxation for base erosion payments will be difficult if there is tax somewhere in the system but not directly at the recipient. The coordination and required communication between jurisdictions would be burdensome, and we are sceptical such communication can be made to work in practice.

Lastly, particularly with respect to the undertaxed payments rule, we believe that the rule should deny deductibility (or treaty benefits in the context of the subject to tax rule) only on a graduated basis depending on the level of effective taxation in the jurisdiction of the recipient, as such a mechanism would help reduce the risk of double taxation. However, as outlined immediately above, this is very often a difficult if not impossible task.

This issue demonstrates the inherent difficulty of designing a well-functioning multilateral foreign minimum tax. Any proposal should (1) only impose tax at a rate not higher than the minimum tax (taking into account foreign taxes imposed and taxes imposed by anti-base erosion regimes) and (2) assure administrative and compliance burdens that are low relative to the revenue raised. In our view, meeting both of these criteria may be an insurmountable challenge.

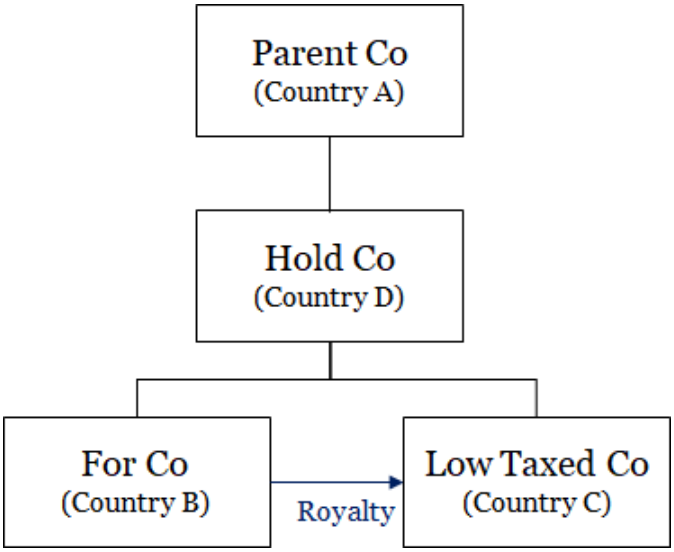
F. Comprehensive Example

To fully illustrate the interaction of these proposals and the potential for egregious triple, quadruple, or even quintuple taxation, we have drafted a short conceptual example with the following facts.[20] Parent corporation ("Parent Co") is incorporated in Country A. Country A has implemented an income inclusion rule that is applied on a country-by-country basis. Country

[20] To avoid additional complexity in this simple example, we have intentionally excluded the interaction of the proposals in Section 2 of the PCD and potential for additional layers of taxation. However, as discussed above, any proposed measure must ensure proper coordination of the provisions outlined in Sections 2 and 3.

A's minimum tax rate for purposes of applying the rule is 10 percent. Country A also applies a 100% credit for foreign income taxes deemed paid (with no indirect expense apportionment).

Parent Co owns an entity located in Country D ("Hold Co"). Country D has implemented an income inclusion rule that is applied on a country-by-country basis. Hold Co in turn owns foreign corporation ("For Co") incorporated in Country B. Country B's tax rate is 25 percent. Country B has implemented both base eroding payments proposals in the PCD, which also applies a 10 percent minimum rate of tax for application. Hold Co also owns an entity located in low-taxed Country C ("Low Tax Co"). Country C has a tax rate of 2 percent. For Co makes a royalty payment to Low Tax Co on an arm's length basis in accordance with the final Action 8-10 BEPS reports. Article 12 of Country B's double tax treaty with Country C provides 0 percent withholding on royalties, whereas the statutory withholding tax rate on royalties is 5 percent in Country B. Low Tax Co is taxed at an effective rate of 2 percent in Country C for the related royalty income. An illustration of the structure and transaction is provided below:



As provided in the PCD, we first start with the subject to tax rule, under which For Co would be denied treaty relief on the royalty payment, as such income was not sufficiently taxed (i.e., not at 10 percent) at Low Taxed Co. Without treaty relief, the zero rate of tax provided by Article 12 would be ignored and the royalty payment would be subject to 5 percent withholding tax under Country B's statutory rate. Next, when applying the undertaxed payments rule, the effective rate of tax is expected to be 7 percent (i.e., 5 percent withholding by way of the subject to tax rule and 2% under the domestic rate in Country C). As such, the income would still be deemed insufficiently taxed and, by operation of the undertaxed payments rule, the royalty deduction would be denied. Consequently, the entire royalty amount would be subject to tax at 25 percent under the normal corporate tax rate in Country B.

Lastly, when applying the income inclusion rules of Country A and Country D, we would test the ETR on a country-by-country basis. Per the high statutory rate (and additional taxation paid under the other regimes) we would expect Country B to have a sufficient level of taxation.

However, the royalty income earned at Country C was only subject to tax at 2 percent under the domestic corporate income tax rate. As a result, we would expect an inclusion of the entire royalty amount subject to tax in Country A at either 10 percent or the full statutory rate (net of a potential 2% foreign tax credit, absent dilution by some mechanical calculation). Similarly, we would also expect an inclusion in Country D at Hold Co, provided coordination rules did not clearly define which jurisdiction has the right to tax between Country A and Country D.

As a result of the normal domestic regimes as well as the new rules implemented, the royalty income received by Low Taxed Co is taxed a total of five times - (1) Country C domestic rate of 2 percent, (2) Country B withholding tax of 5 percent, (3) Country B domestic rate of 25 percent, (4) Country D at either 10 percent or the domestic rate - with varying degrees of foreign tax credit offset and (5) Country A at either 10 percent or the domestic rate - with varying degrees of foreign tax credit offset.

Some of the double taxation risk noted above may be mitigated by way of coordination rules, foreign tax credits, and other safeguards. However, CFC-type rules diverge across countries and we fully expect such to continue even with implementation of these proposals. As such, we would expect to see much of the potential risk above in practice once rules are enacted.

G. Administrative burden

In addition to the broader administrative challenges outlined below, we expect the compliance burden related to the global anti-base erosion proposals to significantly increase regardless of approach, as each new regime would add layers of complexity and additional work to an already complicated system. This additional burden is clearly evidenced by the U.S. GILTI regime, which introduced several new concepts and reporting requirements, while maintaining effectively all legacy anti-abuse rules.

Unless each country adopts identical standards and rules, each system also results in the additional burden for taxpayers to assess whether such rules apply followed by a determination of required compliance and tax payments. This effect of differing, complex regimes being introduced by each country is already occurring as a result of rules introduced under Action 13 and other Actions noted above.

Income inclusion rule

We believe practical limitations to the income inclusion rule would suggest a narrow application and scope and would make the proposal more easily administered. For example, increasing the ownership threshold would avoid shifting the burden to minority shareholders with limited ability to comply due to restricted access to relevant data and information. Additionally, many small and medium enterprises (SMEs) with international footprints are barely keeping up with existing compliance requirements, so safe harbours exempting certain categories of businesses would also be welcomed. Introduction of new compliance requirements and taxation is expected to reduce economic growth and stifle competition, which is of particular concern for SMEs.

Simplification measures may help reduce the time required for (1) applying the rules and (2) reporting in accordance with the rules. We would suggest certain safe harbours to reduce analysis where possible on the front-end of applying the rules (e.g., such as completely exempting certain jurisdictions with rates deemed sufficient). Similarly, we believe the exclusion of routine returns from the income inclusion rule could reduce the administrative burden while also maintaining the aims of the measure, as such arrangements do not contain areas of concern highlighted by the OECD (i.e., highly-mobile intangible and financing income).

We believe aggregate tests should also be considered in the context of both double taxation and compliance. Aggregate tests, as opposed to country or entity level determinations, would be more administrable while also accomplishing the goal of ensuring a minimal level of global taxation for MNEs. Country- and entity- level tests require taxpayers and administrators to calculate ETR on a more detailed and granular level, an exercise which includes looking through transparent entities to determine where income is subject to tax..

The administrative advantages of an aggregate test over entity and country level tests have been documented.[21] ETR calculations experience less variation over time under the overall approach, as discrepancies due to timing and losses are not as significant. Per country tests also create a strong incentive for low-tax countries to adopt other types of (less transparent) fiscal incentives in lieu of low income tax rates (as discussed above), to potentially raise the effective tax rate for purposes of the minimum tax, while maintaining a fiscal status quo (through direct subsidies or other payments). Finally, as previously noted, the country and entity level tests create more opportunity for double taxation, as these approaches require calculations of ETR on a more granular level.

Tax on base eroding payments

Similar to the scope limitations suggested for the income inclusion rule, restricting application of the tax on base eroding payments to certain, narrowly defined payments will also reduce complexity and administrative burden. As a practical example, the U.K. hybrid rules contain a broad definition of what constitutes a payment within the purview of the rule. Without sufficient exemption, there is a chance of multiple levels of taxation through application to non-abusive payments, most likely not intended to be affected by these rules, such as cost of goods sold.

The breadth of such a rule and related exercise, requiring review of all "payments" in the value chain, is incredibly onerous on taxpayers. Similarly, and as discussed in more detail below, the result has no connection at all to the underlying economics as the same payments to different parties are treated differently.

Similar to above, there is significant opportunity for simplification measures with respect to the base eroding payments proposals. For example, payments to certain jurisdictions may be completely exempted from the analysis. This approach would simplify the analysis, as it would remove the need for doing the ETR calculation, which depending on approach may be complicated. Payments for direct costs may also be excluded, as such do not raise significant base erosion concerns when compared to other payments (e.g., interest, royalties, etc.).

[21] Grubert, Harry and Altshuler, Rosanne, F*ixing the System: An Analysis of Alternative Proposals for the Reform of International Tax* (April 1, 2013). Available at SSRN: https://ssrn.com/abstract=2245128.

Further, we strongly believe the payments within the scope of such a rule should be limited to payments to related parties. Unrelated persons rarely have access to sufficient information and data and may have issues to properly comply with this requirement, not to mention the business and legal impediments to accessing such data (e.g., safeguards around proprietary and legal information) and ancillary issues.

Appendix 2

Survey on the use of Profit Split Method – the practical implications

This questionnaire seeks to provide statistical information on the use of profit split methods (PSMs) by asking our global Transfer Pricing (TP) network to test the practical feasibility and implications of adopting such methodology for the entities in their territories.

On 13 February 2019, an online survey was created to collect results from our global TP network particularly our core group of countries. The questions in the survey were intended to reflect the number of PSMs applied throughout the network and common difficulties applying such methodology either as part of an APA, dispute resolution or otherwise.

The conclusions stated herein are based on our network's practical experience of cases seen or projects performed. While we believe that the results of this survey are meaningful and supportable, it is not intended to provide a complete picture which the OECD or any tax authority should wholly rely on. The intention is to provide experience-based information on how many PSMs are applied in similar circumstances and what transfer pricing practitioners typically have to address when grappling with the application of PSM. Cross analysis between questions should not be attempted as the country numbering may not be consistent.

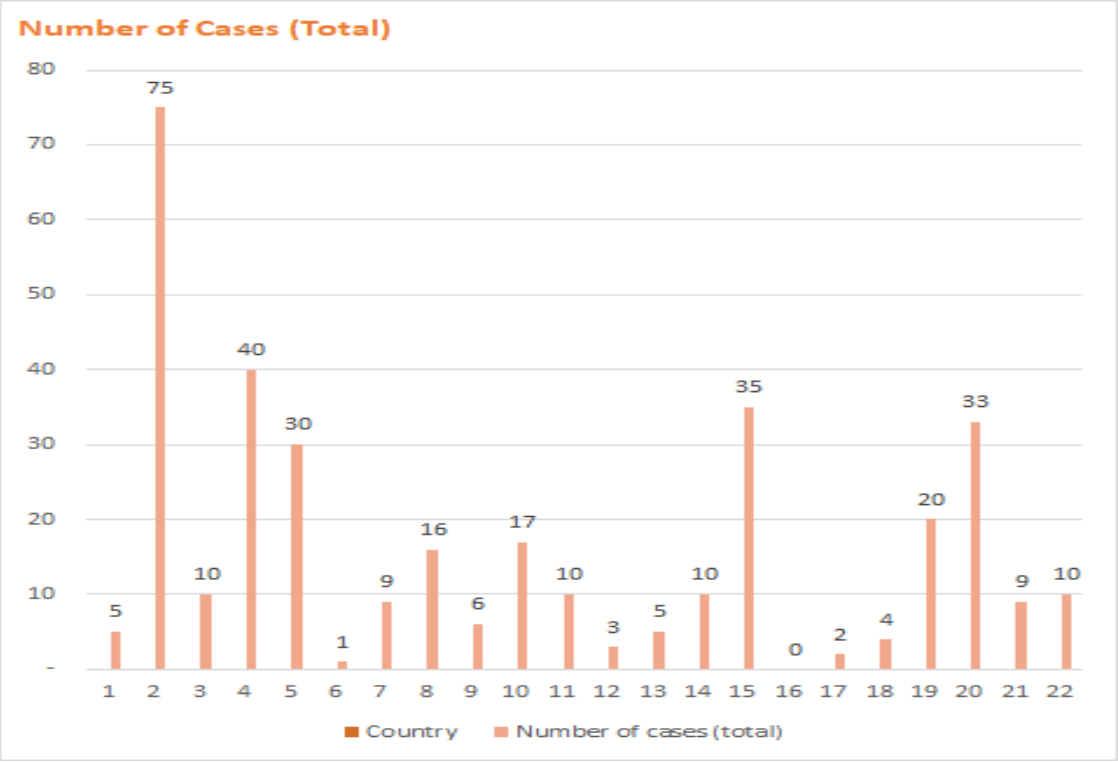
The following countries have participated in the survey (22 countries in total):

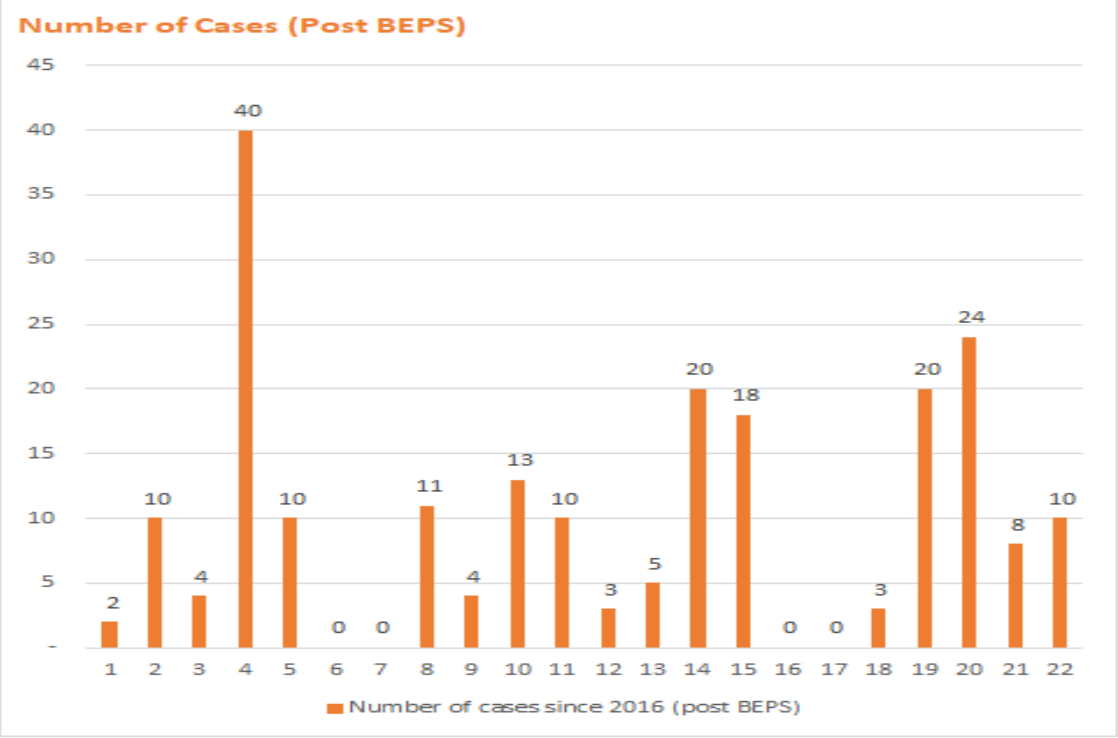
Survey on use of PSM - Countries

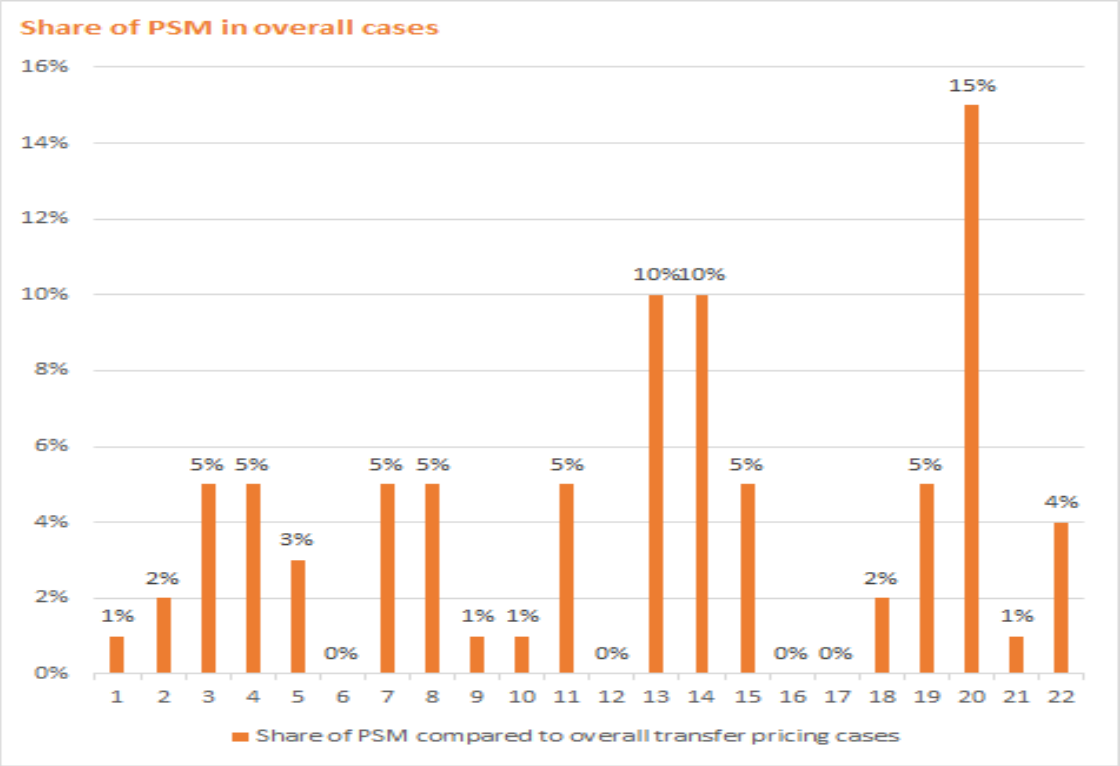
Australia	Denmark	India	Middle East	Sweden	US
Belgium	France	Indonesia	Singapore	Taiwan	Vietnam
Canada	Germany	Ireland	South Korea	The Netherlands	
China	Hungary	Italy	Spain	UK	

Questions

1. **Please indicate how many profit split cases has your team worked on or encountered over the last years (ideally over last 10 years). If possible, please indicate separately the number of cases since 2016 (post BEPS). Indicatively, what share would this represent of the overall transfer pricing cases and what industries are most common to have used a PSM?**


Number of Cases (Total)
80
70
60
50
40
30
20
10
-
5
75
10
40
30
1
9
16
6
17
10
3
5
10
35
0
2
4
20
33
9
10
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22
Country
Number of cases (total)


Number of Cases (Post BEPS)
45
40
35
30
25
20
15
10
5
-
2
10
4
40
10
0
0
11
4
13
10
3
5
20
18
0
0
3
20
24
8
10
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22
Number of cases since 2016 (post BEPS)



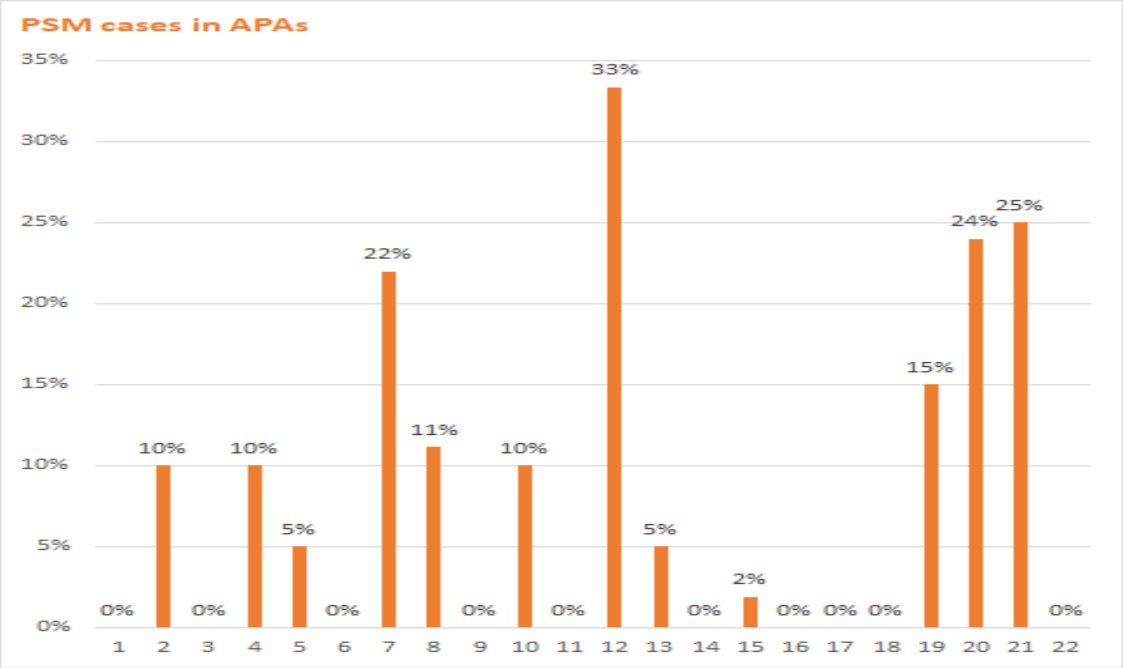
Percentages in the charts show that PSMs are very rarely applied in the territories and more traditional approaches are common. Including the vast majority of MNCs, transaction based methods and TNMM methods are used mostly. Although we have formulated and applied PSMs and RPSMs, profit split methods only represent about 5-10% of all the methods applied.

Industries involved

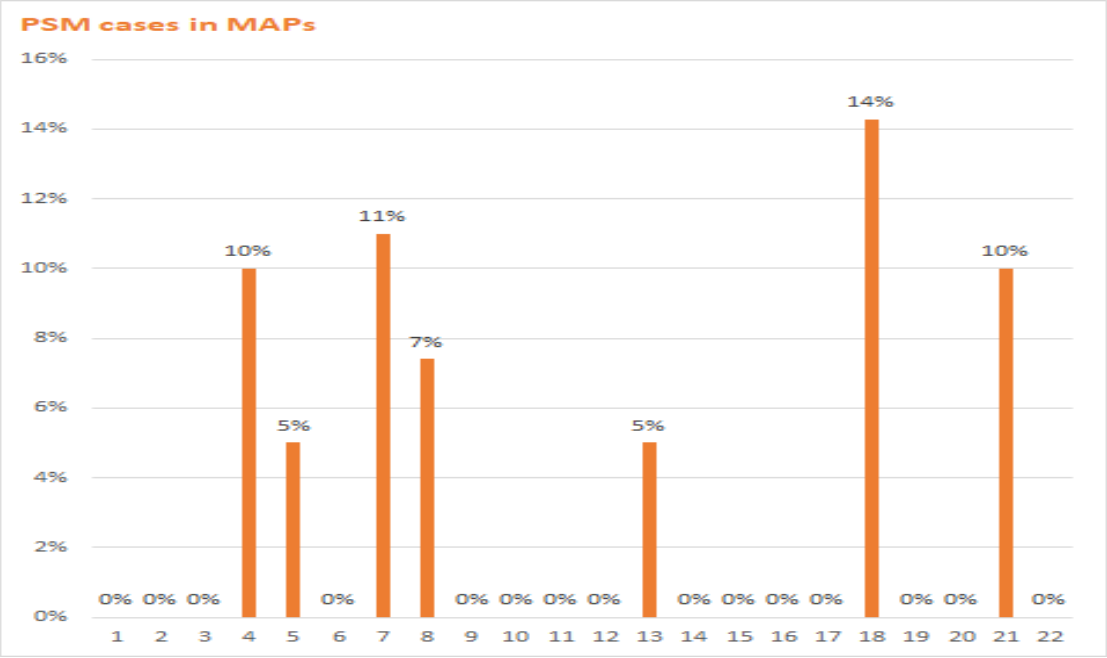
Industries mentioned in the survey range as follows: financial services, telecom, pharmaceuticals, technology companies, automotive, entertainment, consumer goods, FMCG, energy, infocomm, retail, services, transportation.

2. In the figures referred to above, please give an indication of the number or percentage of cases involving PSM that were used in the framework of an advance pricing arrangements, mutual agreement procedure or regular audit procedure.

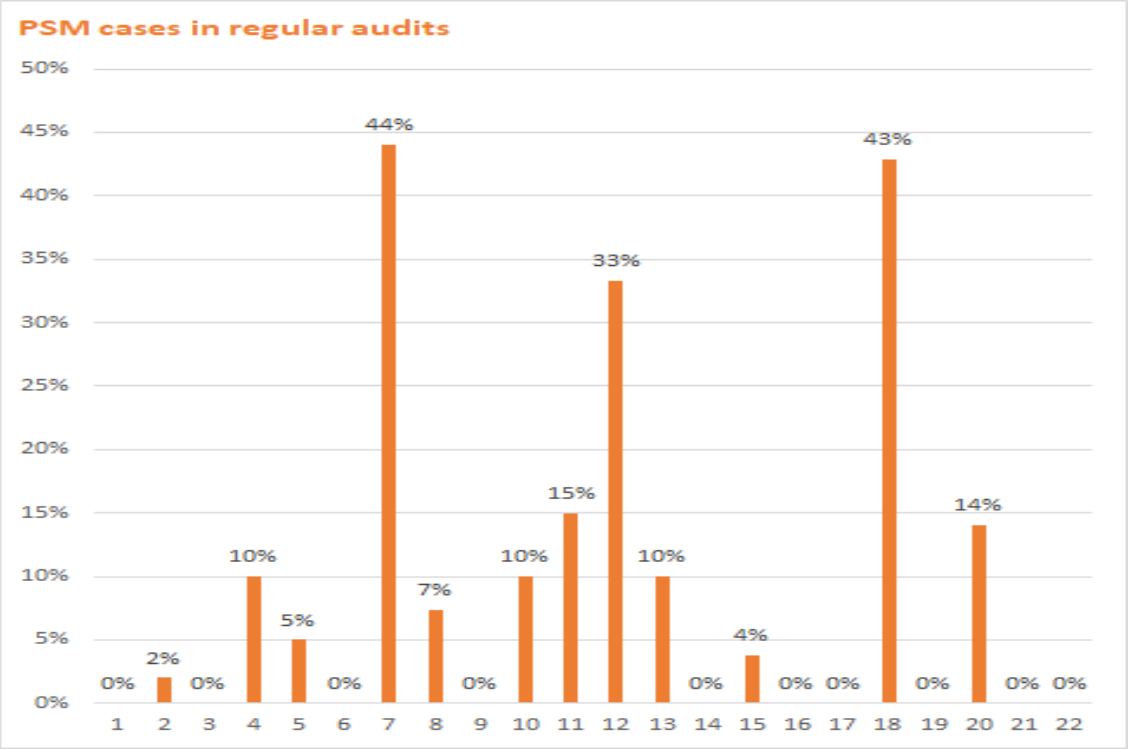
Advance Pricing Arrangements



Mutual Agreement Procedures



Regular audits



3. Please indicate how many cases used a residual analysis or a contribution analysis

Country	Residual analysis in PSM	Contribution analysis in PSM
1	2 cases	None
2	2%	None
3	10 cases	None
4	Mostly applied	Less often applied
5	Great majority	Negligible
6	1 case	0
7	2 cases	7 cases
8	5 cases	4 cases
9	5 cases	1 case
10	15 cases	2 cases

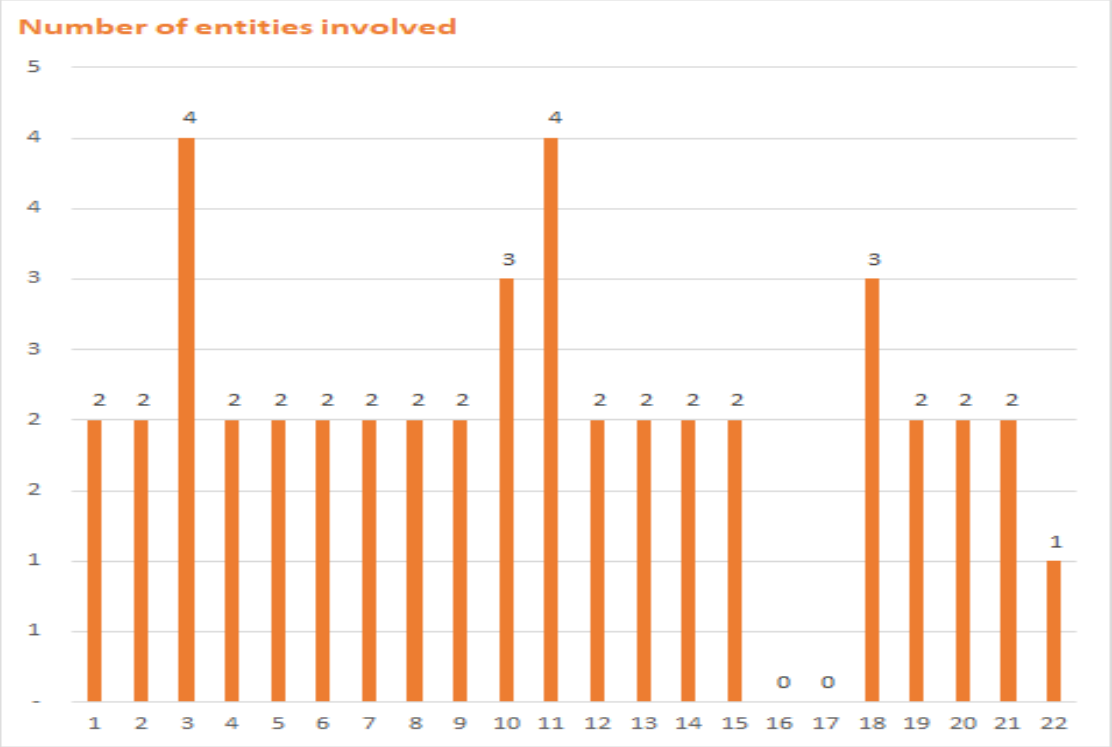
11	10 cases	10 cases
12	3 cases	None
13	Most of the cases	Few of the cases
14	None	Most of the cases
15	23 cases	12 cases
16	None	None
17	None	None
18	2 cases	2 cases
19	Mostly applied	Less often applied
20	25 cases	7 cases
21	80% of the cases	20% of the cases
22	Unknown	Unknown

4. Split factor used

Country	Split factors used
1	N/A
2	Cost based factors (e.g. marketing expenses), Asset based factors (e.g. marketing intangibles or other assets), R&D for manufacturing IP, Advertising for marketing IP, legal costs for both. Other relevant investments for network intangibles.
3	Cost based factors (e.g. marketing expenses), Asset based factors (e.g. marketing intangibles or other assets)
4	Cost based factors (e.g. marketing expenses), Asset based factors (e.g. marketing intangibles or other assets)
5	Cost based factors: weight of relevant functions
6	Asset based factors (e.g. marketing intangibles or other assets)
7	Process contribution based on qualitative weights of importance
8	Functional contributions and combination of weighted RFAs
9	Cost based factors (e.g. marketing expenses)
10	Asset based factors (e.g. marketing intangibles or other assets): People

11	Bargaining Power Theory, Contribution Analysis
12	Cost based factors (e.g. marketing expenses), Other (Equal contribution)
13	Cost based factors (e.g. marketing expenses)
14	Asset based factors (e.g. marketing intangibles or other assets), SPF/ASSETS
15	N/A
16	N/A
17	N/A
18	Cost based factors (e.g. marketing expenses) Compensation, marketing expense
19	Senior headcount, senior staff compensation, random rule of thumb (50/50), Management remuneration / headcount, weighted update
20	Cost based factors (e.g. marketing expenses), Asset based factors (e.g. marketing intangibles or other assets), Other: headcounts, revenue, value contribution, value chain analysis venue, value chain analysis.
21	Cost based factors (eg marketing expenses), Asset based factors (eg marketing intangibles or other assets), Value Chain analysis
22	N/A

5. Please indicate how many entities were typically involved in the PSM?



6. Main difficulties and uncertainty in the use of a PSM

- Subjectivity of the analysis.
- Data availability, allocation keys to be used (determination of split factors), complexity.
- Definition and agreement on profit to be split and manner in which it is split.
- Verifying and supporting the factors used for the profit split.
- Lack of familiarity from tax authorities.
- Verification of the overseas information, including overseas entity's financials and allocation/appropriation methods.
- Accurate information on historical investments in IP, capitalisation rate for investments in IP, determination of useful life of IP and the discount rates.
- Subjectivity of contribution analysis i.e. importance of each function and split between entities. Basis of allocation; key/split factor. Calculation of total system profits subject to the profit split. Determining appropriate allocation key(s).
- Challenge to implement, maintain and monitor the PSM, choice of appropriate splitting factors, application to a partnership where management remuneration is profit share rather than salary, choice of appropriate splitting factors, determining the profits to be split, dealing with third countries which also had a role but not as much as the two in the profit split.
- Calculating the split and determining split factor, determining the part of other activities not being part of the PSM, complexity to monitor the PSM, complexity of determining the system profit in case more than 3 parties are involved in the PSM

- Access to reliable internal data and difficulties in finding a sufficiently robust split mechanism.

7. Main elements or reasons creating uncertainty

- Subjectivity of the analysis.
- Assumptions that cannot be fully validated by complete, accurate and reliable data.
- The subjective determinations of residual profit/comparable adjustments/determining system profitability.
- Weighting of the factors.
- Subjectivity, lack of common understanding of industry factors.
- Lack of application and experience in general. Also requirements of robust documentation and information involving all parties are cumbersome.
- PSM's focus of using the information outside of the domestic market.
- Decision to split at gross or net factor, full or segmented PL.
- Allocation keys viewed as highly subjective, inability to verify reliability of profit split input data.
- Nontraditional method and risk of challenge by tax authorities, even more for loss split allocation.
- The tax authorities' request to perform a sanity check against a one-sided methodology, changes in local legislation indirect tax implications, documentation requirements and (legal) income characterisation (e.g. registration of IP, currency control), issues related to customs.

8. Marketing intangibles and PSM- What is your experience on PSM in dealing with marketing intangibles?

- We have incorporated marketing intangibles in RPSMs with these typically attracting a modest return.
- Included a marketing royalty in a RPSM on a few occasions only.
- No marketing intangibles were involved in the profit split we performed.
- There is subjectivity in identifying spend associated with the intangible and determining the value of the intangible.
- We do not have any experience on PSM yet in dealing with marketing intangibles.
- Marketing intangibles are commonly used argument in relationship with or without PSM.
- Applied to set royalty rates (residual profit split).
- Weighing of the marketing intangibles in the split.
- Not much on PSM but commonly encountered in TNMM for distributors

9. Any other issues or comments?

- There is nothing in our local regulations that would suggest that the application of profit split methods will increase substantially in the near future.

- Although we recognise that in a post BEPS environment, most tax authorities may assert the un-principled application of profit split, whether they prevail in imposing transfer pricing adjustments will largely depend on the specific country tax laws and legal precedents. We believe that in our territory, the taxpayers will continue to have the upper hand in demonstrating that there is plenty of transaction and profit based information that can be used to evaluate reliable arm's length ranges and that profit split methods should only be used should they be effectively the most appropriate method.
- We do not include PSM used in the context of Patent Box under the BEPS Action 5 nexus approach.
- In our territory, the PSM has traditionally probably been the method that has had the least application of the five alternatives TP methods. This is not to say that in audits, APAs, MAPs etc, that the tax authority has not considered overall profit and how it is split between the related parties, but in most instances the method that has actually justified the arm's length nature has been another method (mostly TNMM, in second order probably CUP).
- The foreseeable future, based on the revised Guidelines as well as the increasing amount of information (and thus perspective) available to the tax authority, the expectation is that a greater part of the discussion will be centred on how the overall profits are shared and, potentially, an increased frequency of PSM applications.
- PSM was rarely applied in our transfer pricing landscape thus far. However, in the recent discussions with the Tax authorities, it appears that the tax office are advocating / proposing PSM methods in cases where they are of the view that operations are highly integrated in nature and a standalone analysis does not provide an arm’s length result.